Petition

81-703

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No. . . .
IN THE

Supreme Court of the United States

October Term, 1981

ORA E. GAINES, on behalf of himself and other similarly situated shareholders of Lockheed Aircraft Corporation,
Petitioner,

vs.

D. J. HAUGHTON, A. C. KOTCHIAN, R. A. ANDERSON, C. CHAPPELLET, D. M. COCHRAN, C. S. GROSS, W. M. HAWKINS, J. K. HORTON, C. L. JOHNSON, and LOCKHEED AIRCRAFT CORPORATION,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

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Questions Presented.

1. May a shareholder assert a claim under section 14(a) of the Securities Exchange Act of 1934 for infringement of his right to a fair election of directors, irrespective of whether he personally relied on allegedly false and misleading proxy materials, when those materials had a propensity to influence the votes of other shareholders?

2. Where proxies are solicited for re-election of directors, is information relating to the nominees' qualifications *per se* non-material as a matter of law where it is alleged in a claim brought under section 14(a) that the proxy soliciting documents failed to disclose that

(a) the nominees knew of and participated in the making of millions of dollars in illegal and questionable payments by the corporation to foreign government officials;

(b) the illegal and questionable payments were central to the corporation's business and exposed the corporation to significant potential adverse financial consequences; and

(c) the nominees subverted the corporation's financial accountability system by their concealment of the payments through the authorization and use of false corporate books and records and off-book accounts, and through their misrepresentations to the company's auditors;

and later proxy soliciting materials allegedly affirmatively misstated the nominees' involvement in those activities?

Parties to the Proceedings in the Court of Appeals.

The parties to the proceedings in this case before the Court of Appeals for the Ninth Circuit are the parties listed in the caption for this petition.

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Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

The petitioner respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered in this proceeding.

OPINIONS AND ORDER BELOW.

The order of the Ninth Circuit Court of Appeals denying the petition for rehearing and suggestion for rehearing en banc is printed as Appendix A.

The opinion of the Ninth Circuit Court of Appeals is printed as Appendix B, and is reported as *Gaines v. Haughton, et al.*, ... F.2d ... (9th Cir. 1981).

The memorandum of the United States District Court for the Central District of California setting forth the grounds supporting its decision granting defendants' motion to dismiss and motion for summary judgment is printed as Appendix C.

JURISDICTION.

The opinion of the Ninth Circuit Court of Appeals was entered on May 18, 1981.

The order denying the petition for rehearing was filed July 10, 1981.

Jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES INVOLVED.

Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n.

STATEMENT OF THE CASE.

A. The Complaint.

On February 24, 1976, Ora Gaines, a stockholder of Lockheed Aircraft Corporation, filed the present class action against Lockheed and various of its officers and directors, alleging that since 1961, Lockheed and certain individual defendants had engaged in a practice of making illegal and questionable payments of "enormous sums of money" to foreign government officials and others under the guise of fees to "consultants" and "foreign sales agents," in order to consummate foreign sales of Lockheed aircraft and equipment. (Complaint ¶ 13.) From 1970 to 1975, Lockheed allegedly made at least $202 million of such payments, at least $22 million of which was authorized and expended by Lockheed officials for bribery, pay-offs, and other corrupt business practices. (*Id.*) In order to conceal the nature and amount of these payments, Lockheed and certain individual defendants allegedly authorized and used various deceptive practices, such as false entries in the company's books and

records, off-the-books funds, and laundering funds through subsidiaries set up exclusively for such purpose. (*Id.* ¶¶ 14, 30.)

By 1973, payments to such foreign "consultants" had become sufficiently substantial that Lockheed's independent auditors brought the matter to the attention of the board of directors' audit committee, on which two of the defendants served. The committee is alleged to have allayed the concerns of the auditors by concealing and misrepresenting information regarding such payments. (*Id.* ¶¶ 15, 30.) All such payments were treated as deductible business expenses for federal income tax purposes, even though payments which are illegal under foreign law are allegedly not tax deductible. (*Id.* ¶ 16.)

The complaint alleged that, in violation of Section 14(a) of the Securities Exchange Act of 1934 and Rule 14a-9 thereunder, each year from 1961 through 1974 the management of Lockheed solicited proxies from the company's shareholders for the election of directors on the basis of proxy solicitation materials which were false and misleading with respect to material facts, and which omitted to state material facts necessary in order to make statements therein not misleading, in connection with the above-described activities. (*Id.* ¶¶ 26-36.) These proxy materials allegedly represented that all nominees for the board of directors were qualified to serve as fiduciaries, and that the financial statements appended to the proxy materials fully and fairly represented Lockheed's financial position. (*Id.* ¶ 29.) The materials failed to disclose the nature and scope of the foreign payments, the methods utilized to conceal them (including the making of misrepresentations to the company's auditors), the knowledge of and involvement in such practices by the directors, the corporation's potential liability for substantial penalties occasioned by the illegal conduct, and the significant damage to the company's goodwill and potential income from foreign and domestic sales of its

aircraft and other equipment. (*Id.* ¶¶ 14, 25, 30.) All the defendant directors were elected on the basis of such allegedly false and misleading proxy materials. (*Id.* ¶ 34.)

Plaintiff sought equitable relief for the alleged violations of section 14(a), including the injunction of further dissemination by Lockheed of materially misleading proxy solicitation materials, the voiding of previous director elections based on the earlier misleading materials, and the preparation of new proxy materials which would fully and accurately disclose to the shareholders the history and concealment of the illegal and questionable payments and the involvement in these activities of the various Lockheed directors. Plaintiff also brought certain state-law-based derivative claims seeking money damages from the individual defendants.

B. The Proceedings Below.

Shortly after the action was commenced, Lockheed successfully moved on April 9, 1976 for a stay of all proceedings, including a stay on all discovery by plaintiff to substantiate the allegations of his complaint, until a Special Review Committee ("SRC") of three (later seven) of its board of directors could, with the assistance of Special Counsel, investigate the matters in question and issue a Report. The SRC Report was issued in June 1977, and was sent to all Lockheed shareholders as part of its 1977 proxy materials.

Lockheed's Special Litigation Committee ("SLC") thereupon brought a motion to dismiss plaintiff's 1934 Act federal claims and a motion for summary judgment as to plaintiff's derivative state law claims. Plaintiff contended in response that the SRC Report sent to the shareholders was itself materially misleading: although it largely confirmed the allegations of plaintiff's complaint, the SRC Report allegedly "covered-up" and misstated certain additional highly material information regarding the direct in-

volvement of certain Lockheed directors in the improper payments and in the false accounting practices. The material information allegedly misstated and omitted by the SRC Report was contained in a secret appendix prepared by the SRC's Special Counsel. The secret appendix was not sent to shareholders, but had been shown to plaintiff's counsel under the District Court's protective order. Plaintiff also contended that, because of the District Court's previous stay order, plaintiff had been allowed no discovery at all "on the merits" — except for being allowed to examine the secret appendix. Plaintiff brought a preliminary injunction motion seeking that the misleading information contained in the SRC Report be corrected by a further report to the shareholders accurately setting out the information in the secret appendix relating to the individual directors' involvement in the illegal and questionable payments.[1] This motion was taken off calendar by the District Court until Lockheed's motions for dismissal and summary judgment were favorably ruled upon by it.

In granting Lockheed's motions and dismissing this action, the District Court concluded that, because plaintiff could not allege that he himself had granted a proxy based on the alleged false and misleading proxy solicitations, plaintiff had no standing, as a matter of law, to assert a direct section 14(a) claim. Further and alternatively, the District Court concluded, as a matter of law, that there was no "transaction causation" between the alleged misstatements and omissions in the proxy solicitation materials and any alleged harm ensuing to the Lockheed shareholders.

The Ninth Circuit affirmed. The appellate court agreed that plaintiff lacked standing to assert a direct, rather than a derivative, claim under section 14(a). Only a shareholder

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[1]Because of the District Court's order staying all proceedings, plaintiff was never provided the opportunity to amend his complaint to reflect the factual matters relating to the 1977 proxy materials alleged in his preliminary injunction motion and in response to Lockheed's motions.

who was "actually deceived" by the proxy solicitation materials and could allege that he personally had granted a proxy in reliance on those materials could bring such an action. Slip op., at 2255-56.

The Court rejected the District Court's "transaction causation" approach, because plaintiff's section 14(a) claim was an equitable one contesting the election of directors, not one for damages. Nevertheless, in the Ninth Circuit's view, an alternative ground for affirming the District Court's dismissal of plaintiff's section 14(a) claim existed, since the alleged misstatements and omissions were not "material" as a matter of law. In so holding, the Court drew a "sharp distinction" between two kinds of director misconduct. Misconduct which involves self-dealing, the Court stated, is "presumptively material." But the conduct at issue here was simply a matter of "business judgment, soundly entrusted to the broad discretion of the directors," and, as such, is "never" material. *Id.* at 2259-61. In such matters, the Court of Appeals stated, aggrieved shareholders have sufficient recourse to state law remedies and, "if all else fails, can sell or trade their stock in the offending corporation in favor of an enterprise more compatible with their own personal goals and values." *Id.* at 1161. In the absence of self-dealing, the Court of Appeals held, director misconduct is "simply not material or otherwise within the ambit of the federal securities laws." A contrary holding, the Court of Appeals warned, would "represent a move toward the federalization of corporate law that the Supreme Court has repeatedly and emphatically rejected," citing *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977). *Id.* at 2262.[2]

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[2]The Ninth Circuit also affirmed the District Court's dismissal of plaintiff's state law derivative claims, concluding that, even if the SLC were negligent in its decision to dismiss plaintiff's monetary claims against the individual defendants, the SLC's decision was dispositive, so long as made in good faith. Slip op., at 2254.

Upon learning of the panel decision below, the Securities and Exchange Commission ("SEC") moved for leave to file out of time an amicus curiae brief in support of a petition for rehearing and rehearing *en banc*. According to the SEC's motion, the panel opinion "significantly narrows the investor protections afforded" by section 14(a) and Rule 14a-9. Indeed, the "legal standards articulated in the decision, if applied in future cases, could have serious adverse effects both on the enforcement of the federal securities laws by the Commission and on the maintenance of private rights of action under these laws." (Motion of the SEC to File a Memorandum, Amicus Curiae, Out of Time, at p. 1.) The SEC maintained that the holding below limiting direct actions to "shareholders who were actually deceived" conflicts with *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), and other circuit court decisions on that issue, and it "unduly restricts private actions for enforcement of the proxy provisions by precluding actions by, among others, proxy contestants, any shareholder who votes against management, and shareholders seeking injunctive relief prior to an election when the shareholder has not yet given a proxy." (Memorandum of the Securities and Exchange Commission, Amicus Curiae, in Support of Petition for Rehearing and Rehearing *En Banc* (hereinafter "SEC Amicus Brief"), at pp. 4-5.) Further, according to the SEC, the panel's "incorrect and unduly restrictive interpretation" of section 14(a) formulates a *per se* "litmus paper test" of materiality for "particular subject matters" which disregards both Congressional intent and the consistent rulings of such landmark Supreme Court cases as *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), that materiality is ordinarily a question for the trier of fact. In addition to conducting an extensive nation-wide "Voluntary Disclo-

sure Program,"[3] the SEC had brought roughly 50 enforcement cases alleging violations of the federal securities laws stemming from allegations similar to those made here by plaintiff: "The panel decision in this case is the only court of appeals decision of which [the SEC is aware] that refuses to accept any theory of materiality underlying these cases." (SEC Amicus Brief, at pp. 3-4.)

The Ninth Circuit panel denied the SEC's motion for leave to file its amicus curiae brief (Order, July 10, 1981), and the brief was therefore never circulated to the remainder of the judges on the Circuit. The petition for rehearing was also denied on July 10, 1981.

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[3]More than 450 American companies to date have participated in the SEC's "Voluntary Disclosure Program" by publicly disclosing basic information regarding illegal and questionable payments activities to their shareholders and to the SEC on the theory that such information is "material." Securities Exchange Commission 1934 Act Release No. 15,570 (1979), at n.5. *See SEC v. Dresser Indus.*, 628 F.2d 1368, 1370-73 (D.C. Cir. 1980) (*en banc*). *See generally* SEC, Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices to the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess., May 12, 1976 (hereinafter "SEC Report"), at 6-13. Lockheed was *not* one of the companies participating in the voluntary program, but rather was itself the subject of an SEC enforcement action. *SEC v. Lockheed Aircraft Corp.*, No. 76-0611 (D.D.C. 1976). Plaintiff Gaines seeks equitable remedies against Lockheed and its directors beyond the relief obtained by the SEC in its 1976 consent decree. The SEC's amicus brief expressed no views on the appropriateness of the relief requested by plaintiff Gaines, an issue which the Court of Appeals decision expressly refrained from reaching. Slip op., at 2251, n.16.

REASONS FOR GRANTING THE WRIT.

I.

THE COURT OF APPEALS' RULING THAT ONLY SHAREHOLDERS WHO PERSONALLY RELIED ON ALLEGEDLY FALSE AND MISLEADING PROXY SOLICITING DOCUMENTS HAVE STANDING TO ASSERT CLAIMS UNDER THE PROXY PROVISIONS OF THE FEDERAL SECURITIES LAWS FOR INFRINGEMENT OF THE RIGHT TO A FAIR ELECTION OF DIRECTORS IS CONTRARY TO *MILLS V. ELECTRIC AUTO-LITE CO.* AND DIRECTLY CONFLICTS WITH THE HOLDINGS OF AT LEAST TWO OTHER CIRCUITS.

The Court of Appeals' holding that the plaintiff here may not bring a direct section 14(a) claim because he could not allege that he was personally deceived by and relied upon the challenged proxy solicitation materials (Slip op., at pp. 2255-56) fundamentally misconstrues the shareholder interests protected by section 14(a) and disregards the well-recognized principle that a shareholder can be directly injured where, as a result of reliance on deceptive proxy soliciting documents *by other shareholders*, he is deprived of his interest in "fair corporate suffrage."

This Court stated in *J.I. Case Co. v. Borak*, 377 U.S. 426, at 432 (1964):

> The purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation. . . . The damage suffered [from corporate action based on deceptive proxy materials] results not from the deceit practiced on [the shareholder] alone, but rather from the deceit practiced on the stockholders as a group.

Thus, the injury suffered by the individual shareholder "flows" from the damage of inaccurate disclosure to the whole body of shareholders. Whether the individual plaintiff shareholder was personally misled by the proxy materials is irrelevant to the equitable effectuation of section 14(a)'s purpose.

In *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, at 384-85 (1970), this Court recognized the nature of the injury to a shareholder's interest in "fair corporate suffrage" when it held that a plaintiff in a derivative and class action under section 14(a) and Rule 14a-9 does not have to show individual reliance on the misleading proxy solicitation, provided that the misstatement or omission was "material" and thus had "a significant *propensity* to affect the voting process." *Id.* at 394, emphasis in original. The only section 14(a) pleading requirements for equitable relief are that the alleged misstatements or omissions in the proxy solicitation materials must be "material," and that the proxy materials must constitute an "essential link" in the challenged transaction. Proof of "reliance" on the misstatement or omission is simply presumed if the defect was "material." *Id.* at 383. Indeed, the plaintiff in *Mills*, who had alleged that the proxy solicitation materials recommending approval of a corporate merger were defective, had himself voted *against* the merger, as this Court explicitly noted. *Id.* at 388 n.11. *See Mills v. Electric Auto-Lite Co.*, 403 F.2d 429, 435 (7th Cir. 1968). The *Mills* plaintiff — like the plaintiff here — was thus not personally deceived by the false and misleading proxy solicitation. Nevertheless, this Court expressly upheld his private right of action.

At least two other Circuit Courts have ruled directly contrary to the holding of the Ninth Circuit here. In *Dann v. Studebaker-Packard Corp.*, 288 F.2d 201, at 209 (6th Cir. 1961), the Sixth Circuit stated:

> But does a stockholder who has not himself given a proxy pursuant to false and misleading solicitation have standing to assert such right of action? . . . These appellants do not specifically allege that they themselves were misled by the appellees or that they gave appellees any proxies at all. . . . [T]he right sought to be protected by federal law is the right to full and fair disclosure in corporate elections. Therefore, it is not important whether or not the complaining stockholders were deceived — they could suffer equally damaging

> injury to their corporate interests merely because other shareholders were deceived in violation of federal law. Accordingly, they should be entitled to protect themselves against such violations to the same extent as if they, themselves, were the direct victims of the unlawful deception.

See also Greater Iowa Corporation v. McLendon, 378 F.2d 783, at 794 (8th Cir. 1967) ("standing to object to violations of § 14(a) resides in shareholders who are not solicited"); *Gerstle v. Gamble-Skogmo*, 298 F.Supp. 66, at 96 (E.D.N.Y. 1969) ("A stockholder, although he himself may not have been misled or deceived, may nevertheless bring an action under Rule 14a-9 on behalf of the stockholders who as a body were or may have been deceived by misinformation or failure to disclose in the proxy statement"); *Cooke v. Teleprompter Co.*, 334 F.Supp. 467 (S.D.N.Y. 1971) (equitable relief granted under section 14(a) against misleading proxy solicitation where plaintiff was himself seeking rival proxies for contested election of director's seat); *Dillon v. Scotten, Dillon Co.*, 335 F.Supp. 467 (D. Del. 1971) (equitable relief granted under section 14(a) where plaintiffs were ousted as directors by means of a misleading proxy solicitation whose distribution they had opposed).[4]

In arguing for a rehearing below, the SEC stated:

> We are unable to reconcile the panel's conclusion with the Supreme Court's express holding in *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) — a case brought as a direct as well as a derivative action by a

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[4]The Ninth Circuit has itself previously rejected the notion of imposing a "reliance" concept on plaintiffs in section 14(a) actions. *Yamamoto v. Omiya*, 564 F.2d 1319, 1325-26 (9th Cir. 1977) (shareholder is adequate class representative to assert direct section 14(a) claim against misleading proxy solicitation materials despite fact that plaintiff shareholder personally opposed the transaction for which shareholder approval was sought). The Ninth Circuit case erroneously relied upon by the Court of Appeals below, *Klaus v. Hi-Shear Corp.*, 528 F.2d 225 (9th Cir. 1975), addresses the issue of the appropriate equitable remedy under section 14(a), rather than the underlying right of action. *Id.*, at 228, 232.

> plaintiff who voted against management's proposal — that a shareholder's reliance on the allegedly defective proxy solicitation materials need not be established. The panel opinion is also inconsistent with prior decisions of [the Ninth Circuit] and of another court of appeals which accorded standing to maintain a direct action for false or misleading proxy materials to shareholders who opposed the corporate transaction at issue and did not rely on the allegedly deceptive proxy materials. *Yamamoto v. Omiya*, 564 F.2d 1319, 1325-1326 (9th Cir. 1977); *Dann v. Studebaker-Packard Corporation*, 288 F.2d 201, 209 (6th Cir. 1961).

(SEC Amicus Brief, at p. 19.)

The SEC also emphasized its strong practical concerns with the "standing" holding below.

> The [SEC] is concerned that application of the panel's rule limiting direct actions to "shareholders who were actually deceived" unduly restricts private actions for enforcement of the proxy provisions by precluding actions by, among others, proxy contestants, any shareholder who votes against management and shareholders seeking injunctive relief prior to an election when the shareholder has not yet given a proxy. Such direct actions serve as a "necessary supplement" to the [SEC's] own enforcement actions and provide an essential means of redress for injured shareholders. *Mills v. Electric Auto-Lite Co., supra*, 396 U.S. at 382; *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).
>
> * * *
>
> We perceive no rationale for relegating plaintiffs to derivative actions — and to the substantial procedural hurdles that surround such actions — in order to vindicate their right to fair corporate suffrage, merely because they personally have not been deceived. The policies underlying Section 14(a) support the principle that persons with a real stake in the outcome of a shareholder vote . . . should be entitled to vindicate directly their personal interest in fair corporate suffrage.

(SEC Amicus Brief, at pp. 5, 21-22, footnote omitted.)

Additional practical arguments also oppose the holding below. A plaintiff who does not rely on misleading proxy materials about management-sponsored directors is injured in a manner identical to those who are deceived and do grant proxies to management — the wrongdoing directors in question continue to hold office and to manage the company's affairs because they have successfully deceived other shareholders. Further, in order to establish their ability to sue wrongdoing directors, alert or suspicious shareholders who are convinced of the inadequacy of defective proxy materials are now required by the decision below to grant proxies to the very persons who are trying to deceive them. This is surely one of the most perverse "standing" requirements ever judicially created.

II.

THE COURT OF APPEALS' *PER SE* RULE THAT, ABSENT SELF-DEALING, CORPORATE MISMANAGEMENT IS "NEVER" MATERIAL TO SHAREHOLDERS VOTING FOR DIRECTORS IS CONTRARY TO *TSC INDUSTRIES, INC. V. NORTHWAY, INC.*, IS IN DIRECT CONFLICT WITH DECISIONS IN OTHER CIRCUITS, AND COMPLETELY UNDERCUTS THE WIDELY-APPLIED POSITION OF THE SECURITIES AND EXCHANGE COMMISSION.

A. The *Northway* Standard of Materiality Has Not Been Overturned or Modified by *Santa Fe Industries, Inc. v. Green.*

J. I. Case Co. v. Borak, 377 U.S. 426 (1964), recognized that section 14(a) was enacted to ensure "[f]air corporate suffrage" by requiring that proxies be solicited with "explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought." By Rule 14a-9, the SEC has provided that no materially false or misleading statements may be made in soliciting proxies. This prohibition is not limited to particular subject matters; rather it renders actionable any materially false or misleading statements whether they relate to mismanagement or any other subject.

The linchpin of Rule 14a-9 is the concept of materiality. Materiality is peculiarly a factual question and cannot be determined by a litmus paper test such as the Court of Appeals employed below. This Court directed in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), that summary judgment is generally not an appropriate means of adjudicating the "materiality" determination, because that determination requires "delicate assessments" that are "peculiarly ones for the trier of fact" concerning the inferences a "reasonable shareholder" would draw about the significance of a given set of facts. *Id.* at 450. Only if the omissions are so obviously important or so obviously unimportant to a shareholder that reasonable minds cannot differ is the issue of materiality appropriately resolved as a matter of law.[5] Further, the SEC's view regarding the "materiality" of the information in question is entitled to

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[5]*Northway* presented the issue of whether and when materiality may be determined on a motion for summary judgment. A court may grant summary judgment only when "there is no genuine issue as to any material fact." Rule 56(c), Federal Rules of Civil Procedure. In holding that summary judgment was not appropriate in that case, the Court noted by analogy that "the jury's unique competence in applying the 'reasonable man' standard is thought ordinarily to preclude summary judgment in negligence cases." 426 U.S. at 450 n.12.

Here, the issue is presented in the context of a motion to dismiss under Rule 12(b)(6), Federal Rules of Civil Procedure, for failure to state a claim. The allegations in the complaint, therefore, must be taken as true unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim. *See, e.g., Cruz v. Beto*, 405 U.S. 319, 322 (1972); *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). The method of analyzing materiality is essentially the same under a Rule 12(b)(6) motion as it is under a Rule 56(c) motion: under the former the underlying objective facts are *assumed* to be true; under the latter the parties do not dispute those objective facts.

The opinion below largely disregarded many of the critical factual allegations in the complaint. For example, the opinion makes no mention of the alleged illegality of the payments, management's involvement in such illegal acts, the various methods used to conceal the payments and thereby subvert the company's system of accountability, and the allegations of significant potential economic harm to the company.

due consideration in making this case-by-case determination. *Id.* at 449 n.10.[6]

Disregarding the *Northway* analysis and erroneously relying on language in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), the Court of Appeals below opted for a *per se* rule that, absent self-dealing, corporate mismanagement is "never" material. However, despite the Court of Appeals' misplaced reliance on it, *Santa Fe* does not modify *Northway* nor in any way categorically exempt "mismanagement" from the reach of the *Northway* materiality test. *Santa Fe* involved a claim by minority shareholders that a short-term merger between the company and its parent violated section 10(b) of the Securities Exchange Act and Rule 10b-5 because the proposed merger terms were "unfair." The district court had expressly found that there had been no material misrepresentation or lack of disclosure regarding the terms of the merger. 430 U.S. at 474. Noting that *disclosure*, not fairness, is the principal concern of the securities laws, *id.* at 478, this Court admonished against the potential "federalization of corporate law," and held that breach of fiduciary duty alone — without deception — did not state a claim under section 10(b). *Id.* at 474-76. Specifically distinguished in *Santa Fe* was a long line of decisions in which "the breaches of fiduciary duty held violative of Rule 10b-5 included some element of deception." *Id.* at 474-75; *see id.* at 478.

Thus, "*Santa Fe* does not control a case in which information that would prove useful to investors is withheld." *SEC v. Blatt*, 583 F.2d 1325, 1331 (5th Cir. 1978). Where deception is involved, it is no defense to a federal securities claim that the misrepresentation or misleading omission

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[6]It is well-settled that the SEC's interpretation of the federal securities acts is entitled to substantial weight, especially where, as here, the interpretation has been consistently maintained and widely applied. *United States v. Nat'l Ass'n of Securities Dealers*, 422 U.S. 694, 719 (1975).

concerns conduct that constitutes a breach of fiduciary duty.[7] "*Santa Fe Industries* has not meant that every breach of fiduciary duties is necessarily immune from invocation of the rule [10b-5]." *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273, 1291 (9th Cir. 1979); *accord, Goldberg v. Meridor*, 567 F.2d 209, 221 (2nd Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

B. Application of the *Northway* Standard of Materiality Precludes a Finding That the Participation of a Corporation's Board of Directors in the Payment of Vast Sums in Illegal and Questionable Foreign Payments, Their Concealment of Such Payments Through False Books and Records, Off-the-Books Funds, and Misrepresentations to the Company's Auditor, and the Resultant Exposure of the Company to Significant Financial Harm Were Non-Material as a Matter of Law in Proxy Materials Soliciting Votes to Re-Elect the Directors.

Except for the decision by the Court of Appeals in this case, the other circuits addressing the issue to date and the SEC agree that, like self-dealing, the allegations in this case bear a sufficient nexus to the fitness of candidates nominated to serve as directors that materiality may not be foreclosed as "a matter of law."

The decision below is directly contrary to the Second Circuit's decision in *Weisberg v. Coastal States Gas Corp.*, 609 F.2d 650 (2nd Cir. 1979), *cert. denied*, 445 U.S. 951

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[7]Breach of fiduciary duty and securities fraud are not mutually exclusive concepts. Several federal securities cases considered by the Supreme Court involved deception concerning conduct that arguably constituted breach of fiduciary duty. *See Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). *See also Santa Fe Industries, Inc. v. Green, supra*, 430 U.S. at 475 n.15.

(1980), a case virtually on all fours with the instant one.[8] In *Weisberg*, with the knowledge of its board of directors, a company had made $8 million in questionable payments in 1973 and 1974 to a Bermuda corporation, ostensibly as brokerage commissions but allegedly to be passed on as bribes. An audit committee report that the payments were not suspicious allegedly constituted a "cover-up" of the true facts. The proxy materials for 1974 to 1978 did not discuss management's complicity in the bribes nor the subsequent "cover-up" by the audit committee.

The Second Circuit held that the "materiality" of these allegations was distinctly *not* a proper matter for summary judgment, as had been granted for defendants by the District Court. The plaintiff should have been given the opportunity to prove at trial that the directors' involvement in authorizing the improper payments was "material" — even if the directors had not themselves benefited financially from the alleged misdeeds. Plaintiff should also have been given an opportunity through discovery to develop a factual record as to whether any "kickbacks" or other devices had been used to personally benefit the directors or officers in connection with the questionable payments scheme. This discovery opportunity was especially pertinent given the "massive and unexplained over-payments" to the Bermuda corporation. 609 F.2d at 655. Finally, a "cover-up" of the alleged bribes by the audit committee members would be "material," as a matter of law, to shareholders. If such a "cover-up" had taken place, shareholders would doubtless consider that conduct "more important than the initial authorization of payments." *Id.*

Many other decisions have rejected the reasoning of the Ninth Circuit here that, absent self-dealing, corporate mis-

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[8] In contrast to its disregard of *Northway*, the Court below did acknowledge *Weisberg* but expressly declined to follow it. Slip op., at 2259-60.

management is not "material" to shareholders about to vote on proposed directors. *E.g., SEC v. Dresser Industries, Inc.*, 628 F.2d 1368, 1371 (D.C. Cir.) (*en banc*), *cert. denied*, 445 U.S. 529 (1980) (SEC's investigation into a company's questionable foreign payments and concurrent falsification of financial records, and into the adequacy of its disclosure thereof, "plainly" had a legitimate purpose, since "the completeness and accuracy of corporate financial reporting is the cornerstone of federal regulation of the securities markets); *Galef v. Alexander*, 615 F.2d 51 (2nd Cir. 1980) (misstatements regarding proposed changes in stock option plan were material to election of *all* directors, even though only *some* directors stood to benefit financially from allegedly improper transaction); *Maldonado v. Flynn*, 597 F.2d 798 (2nd Cir. 1979) (same); *SEC v. Jos. Schlitz Brewing Co.*, 452 F.Supp. 824 (E.D. Wis. 1978) (a company's expenditure of $3 million for "improper marketing practices and transactions with Spanish affiliates" and concurrent falsification of books and records were not non-material as a matter of law, since the payments had a "direct bearing on the integrity of management" and since discovery might reveal the amount of payments was much greater than alleged); *Herman v. Beretta*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,574, at 94,410 (S.D.N.Y. 1978) (certain directors' approval of $2.3 million in questionable payments and failure to disclose same to full board and to shareholders cannot be characterized as "mere erroneous business judgments in connection with routine corporate business"); *Berkman v. Rust Craft Greeting Cards, Inc.*, 454 F.Supp. 787 (S.D.N.Y. 1978) (failure of certain directors to disclose to full board knowledge of third party's improper profiteering at company's expense is material because it reflects on their "candor" and fitness for office); *SEC v. Kalvex*, 425 F.Supp. 310 (S.D.N.Y. 1975) (failure of director to disclose his participation in "kickback" scheme benefiting other director which utilized false books

and records was material even though he himself did not personally benefit); *Cooke v. Teleprompter Co.*, 334 F.Supp. 467 (S.D.N.Y. 1971) (conviction of director for bribery of local government official is material because other officials may be reluctant to do business with company).

The SEC's well-known and longstanding view, of course, is that information relating to the use by corporate directors of slush funds and false accounts, ostensibly for making improper payments to foreign government officials, is ordinarily "material," and that such information, in fact, would be of "paramount concern" to investors. SEC Report, at 3, 19-24, 30-31. Describing its widely applied "Voluntary Compliance Program" and its enforcement program, the SEC reported to Congress:

> The almost universal characteristic of the cases reviewed to date by the Commission has been the apparent frustration of our system of corporate accountability which has been designed to assure that there is a proper accounting of the use of corporate funds and that documents filed with the Commission and circulated to shareholders do not omit or misrepresent material facts. Millions of dollars of funds have been inaccurately recorded in corporate books and records to facilitate the making of questionable payments. Such falsification of records has been known to corporate employees and often to top management, but often has been concealed from outside auditors and counsel and outside directors.
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> * * *
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> These practices cast doubt on the integrity and reliability of the corporate books and records which are the very foundation of the disclosure system established by the federal securities laws.

SEC Report, at a, 3.[9]

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[9]In *SEC v. Dresser Industries, supra*, the *en banc* Circuit Court observed that the legislative history of the Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78a, 78m, 78dd-1, 78dd-2, 78ff (Supp. I 1977), expressly indicated that it was Congress' intent to "reaffirm" past SEC practice under the 1933 and 1934 Acts regarding corporate activities involving improper payments. 628 F.2d at 1385-86.

The SEC's amicus brief below cogently summarized the fundamental errors behind the Court of Appeals' position that the allegations set forth in the complaint here, which must be accepted as true, can "never" be material under the *Northway* standard.

> In its Report to Congress on Questionable and Illegal Payments, the Commission explained the importance of nondisclosures such as those alleged in this case. That Report rejected a "litmus paper test" of materiality, recognizing the need for a case by case analysis of the "full facts and circumstances" of the nondisclosures prior to any assessment of materiality. SEC Report at 22, 16. Among the factors identified as relevant are the legality of the payments; the financial impact on the company, in terms of the amount of the payments and business dependent thereon, and contingent losses and liabilities engendered by the payments; methods such as false books and records used to conceal the payments; and the extent of the knowledge of or participation in these matters by the company's officers and directors. *Id.* at 13-32. Application of these factors to the allegations here precludes a finding that those allegations are non-material as a matter of law.
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> Plaintiff alleges that certain of Lockheed's officers and directors knew of and participated in substantial and pervasive illegal practices. Such allegations of illegal conduct of corporate affairs certainly are not so obviously unimportant to a reasonable shareholder's evaluation of the fitness of nominees to serve as directors that they may be dismissed as a matter of law. These alleged practices raise substantial questions regarding the "character and integrity of the officers relevant to their management of the corporation," which shareholders might well consider important. SEC Report at 30. *Accord, Securities and Exchange Commission v. Joseph Schlitz Brewing Co.*, 452 F.Supp. 824, 830, 832 (E.D. Wisc. 1978); *Cooke v. Teleprompter Corp.*, 334 F.Supp. 467, 472 (S.D.N.Y. 1971).
>
> Further, the alleged magnitude of the illegal practices, and their centrality to Lockheed's business op-

erations, indicate the pervasiveness of the integrity problem, rendering it even more likely that shareholders would consider such matters important and indeed that shareholders would question the very business competence of directors who have engaged in or fostered such conduct. In this connection it is relevant that, as alleged, the company's independent auditors found the volume of the payments in this case, over $200 million during a five year period, of which $22 million can be established to be bribes, sufficiently significant that they requested an explanation of the payments from the audit committee of the board of directors. The complaint, which must be accepted as true, specifically alleges that the payments "rendered Lockheed potentially liable for substantial penalties * * * and further greatly damaged Lockheed's good will and its potential income from * * * sales of its [products]." (Complaint ¶ 30). While recognizing the importance to shareholders of "*financially* significant information" (slip op. at 2259 n.24) (citation omitted, emphasis in original), the panel disregarded these allegations of material financial impact.

In addition, plaintiff alleges that certain defendant nominees concealed the company's illegal practices by falsifying books and records, maintaining off-book funds, and setting up subsidiaries exclusively for the purpose of laundering funds used for the payments. When Lockheed's independent auditors requested an explanation of certain payments, the company's audit committee allegedly misrepresented and concealed these matters. It is difficult to understand how such alleged intentional actions taken to subvert the company's accountability system can be termed, in the language of the panel, matters of "business judgment[] soundly entrusted to the broad discretion of the directors" (slip op. 2261), which shareholders, as a matter of law, would never consider important in evaluating candidates for election as director. Indeed, in another foreign payments case, the Court of Appeals for the District of Columbia Circuit has recently observed that

> "the completeness and accuracy of corporate financial reporting is the cornerstone of federal regulation of the securities markets * * *."

Securities and Exchange Commission v. Dresser Industries, Inc., 628 F.2d 1368, 1371 (D.C. Cir., *en banc*), *cert. denied*, 101 S.Ct. 529 (1980). *See also Weisberg v. Coastal States Gas Corp.*, 609 F.2d 650, 655 (2d Cir. 1979), *cert. denied*, 445 U.S. 951 (1980). When senior management approves or condones a pattern of such practices, as the complaint alleges here, doubt is thereby cast not only on the integrity of management, but also "upon the whole system of accounting and the integrity of the company's financial statements." SEC Report at 24.

In sum, we submit that, in view of the very breadth of the alleged undisclosed misconduct in this case, it was plainly erroneous for the panel to have concluded that the nondisclosures would be so obviously unimportant to a reasonable shareholder in evaluating the fitness of the nominees to serve as fiduciaries of the corporate trust that this case should be dismissed as a matter of law.

(SEC Amicus Brief, at pp. 15-18, footnotes omitted, emphasis added.)[10]

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[10]Knowledgeable commentators have consistently maintained that improper practices of the type alleged here are "material" matters which must be disclosed to shareholders. *See, e.g.*, SRC Commissioner A.A. Sommer, *The Limits of Disclosure*, Address to the Wharton-AICPA Advanced Management Program (1975), at 8 (secret practices used to extract monies from normal corporate financial accountability strike at the "very core" of the disclosure system created by the federal securities laws); Former SEC Chairman Roderick Hills, Hearings Before the Senate Banking, Housing and Urban Affairs Committee on Oversight of Lockheed Loan Guarantee, 94th Cong., 2d Sess., Mar. 3, 1976, at 80, 91, 92 (the existence of large "off-the-books" payments destroys confidence in the integrity of management and in the accuracy of the books and records, and is *per se* "material"); Former SEC Chairman Ray Garrett, Jr., Address to the Amer. Soc. of Corp. Secretaries, BNA Sec. Reg. & L. Rep. No. 309, at G-1 to G-6 (1975) (questionable payments schemes are "material," not so much because they are "immoral" or otherwise against public policy, but because phony book entries and unaccounted for funds are "wholly inconsistent with financial integ-

(footnote continued on following page)

Finally, the holding below cannot be confined to mere failure to disclose material information regarding director misconduct of the kind alleged here. As previously noted, plaintiff has alleged that the SRC Report, sent to Lockheed's shareholders as part of the 1977 proxy solicitation materials, was itself affirmatively misleading regarding the involvement of the various director candidates in the illegal and questionable payments. The Ninth Circuit's holding that, as a matter of law, the information at issue here is "never" material logically includes not only non-disclosures but express misrepresentations concerning such information, as the SEC observed below. (SEC Amicus Brief, at p. 4.) Any of the many companies required by the SEC's extensive enforcement and/or "voluntary disclosure" programs to disclose information about director misconduct which has done so inaccurately may now be insulated by the ruling below from further proceedings by the SEC or by anyone else regarding these misstatements. This would greatly undercut the SEC's programs, and would substantially undermine the integrity of the disclosure system at the core of the federal securities laws.

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rity"); L. Lowenfels, *Questionable Corporate Payments and the Federal Securities Laws*, 51 N.Y. U. L. Rev. 1, 26-28, 0-31 (1976) (false bookkeeping entries, mislabeling of accounts and phony subsidiaries "strike at the very heart of the disclosure system" and complete disclosure is justified due to their "materiality" in this context); Note, *Disclosure of Corporate Payments and Practices: Conduct Regulation Through the Federal Securities Laws*, 43 Brooklyn L. Rev. 681, 728, 737, 741, 744 (1977) (the SEC's position that improper payments are "material" is "on solid ground" because "virtually all" such schemes involve "deliberate falsification of corporate books and records").

CONCLUSION.

For the reasons set forth above, plaintiff respectfully submits that the decision below conflicts with the well-established holdings of this Court, as well as decisions of other circuit courts. Further, it adversely affects the SEC's extensive enforcement actions and voluntary compliance program in this area, and unduly restricts private actions for the enforcement of the proxy provisions of the federal securities laws.

October 8, 1981.

Respectfully submitted,

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APPENDIX A.

Order Denying Rehearing, Filed July 10, 1981.

United States Court of Appeals for the Ninth Circuit.

Ora E. Gaines, Plaintiff-Appellant, v. D. J. Haughton, et al., Defendants-Appellees. No. 79-3336.

Lois A. and James Fitzpatrick, Plaintiffs-Appellants, v. D. J. Haughton, et al., Defendants-Appellees. No. 79-3516.

Filed: July 10, 1981.

Before: ELY and FARRIS, Circuit Judges, and SOLOMON,* District Judge.

On June 4, 1981, the appellees filed a Petition for Rehearing and a Suggestion for Rehearing En Banc. On June 19, 1981, the Securities and Exchange Commission filed a Motion, seeking leave to file a Memorandum Amicus Curiae out of time.

Judges Ely and Solomon voted to deny the Petition to File an Untimely Brief Amicus and Judge Farris voted to grant it. That Motion is therefore denied.

The panel (Judges Ely, Farris and Solomon) voted unanimously to deny the Petition for Rehearing.

The full court has been advised of the suggestion of en banc rehearing, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed.R.App.P. 35(b).

The Petition for Rehearing is denied and the suggestion for a rehearing en banc is rejected.

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*The Honorable Gus J. Solomon, United States District Judge, District of Oregon, sitting by designation.

APPENDIX B.

Opinion of the Ninth Circuit, Filed May 18, 1981.

Ora E. Gaines, Plaintiff-Appellant, v. D. J. Haughton et al., Defendants-Appellees. No. 79-3336.

United States Court of Appeals, Ninth Circuit.

Argued and Submitted March 3, 1981. Decided May 18, 1981.

Stockholder brought action against various officers and directors of corporation. The United States District Court for the Central District of California, Francis C. Whelan, J., dismissed certain claims and granted summary judgment dismissing other claims, and stockholder appealed. The Court of Appeals, Ely, Circuit Judge, held that board of directors' special committee's determination that it would not be in best interest of corporation to pursue derivative action required dismissal of stockholder's state claims and stockholder failed to state claim under statute making it unlawful to solicit proxies in violation of rules and regulations of the Securities and Exchange Commission.

Affirmed.

Appeal from the United States District Court for the Central District of California.

Before ELY and FARRIS, Circuit Judges, and SOLOMON,* District Judge.

ELY, Circuit Judge:

Ora E. Gaines, the plaintiff-appellant herein, appeals from an order of dismissal and summary judgment for defendants (Lockheed Aircraft Corporation and a number of former and present directors and officers of Lockheed) in

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*Honorable Gus J. Solomon, Senior United States District Judge, District of Oregon, sitting by designation.

a shareholder lawsuit alleging both derivative claims of breach of fiduciary duty/waste of corporate assets and class action claims of federal securities violations. Gaines assigns a variety of errors by the District Court and seeks partial summary judgment and/or remand.

FACTS

From as early as 1961 to as late as 1975, Lockheed engaged in the practice of hiring "consultants" and "foreign sales agents" and paying them large fees and commissions in connection with foreign sales of Lockheed aircraft and equipment. Approximately $30-38 million was paid directly to foreign governments and officials during this period.[1] Shortly after the existence of these clandestine, "off the books" questionable payments was revealed by Securities and Exchange Commission (SEC) and United States Senate proceedings[2] in July-August 1975, Gaines—an individual Lockheed shareholder—commenced his lawsuit in the United States District Court for the Central District of California.[3] Gaines' complaint, filed on February 24, 1976, asserts two derivative causes of action on behalf

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[1]There are no allegations that Lockheed made improper payments to *domestic* officials or that any federal criminal laws were violated by the foreign payments. *See* Special Review Committee Report at 7-15. The Foreign Corrupt Practices Act of 1977, Pub.L.No. 95-213, 91 Stat. 1494, codified at 15 U.S.C. §§ 78m, 78dd-1, 78dd-2, 78ff, was signed into law after the conclusion of the scenario herein. *See generally* Comment, *The Foreign Corrupt Practices Act of 1977: A Solution or a Problem?*, 11 Cal. W. Int'l L.J. 111, 137-39 (1981).

[2]*See Hearings on Political Contributions to Foreign Governments Before the Subcomm. on Multinational Corporations of the Senate Comm. on Foreign Relations*, 94th Cong., 1st Sess. (1975).

[3]A very similar shareholder suit filed on February 17, 1976 in the Southern District of Texas, *Fitzpatrick v. Haughton*, was consolidated with this action in the Central District of California on April 5, 1976. The *Fitzpatrick* plaintiffs, however, did not perfect an appeal from the order of dismissal/summary judgment and, thus, are no longer in the case.

of the corporation and two class action counts on behalf of the shareholders.

The derivative causes of action—based on California law since Lockheed is a California corporation[4]—allege that the individual defendants[5] breached their fiduciary duty to the

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[4]An independent jurisdictional basis for these pendent state law claims is diversity of citizenship, as Gaines is a citizen of Georgia. 28 U.S.C. §§ 1332(a)(1), (c).

[5]Named as individual defendants were: D.J. Haughton, A.C. Kotchian, R.A. Anderson, C. Chappellet, C.S. Gross, W.M. Hawkins, C.L. Johnson, D.M. Cochran, and J.K. Horton. When the complaint in this case was filed, the Lockheed board was composed of fifteen directors. Gaines avers on appeal that seven Lockheed board members (D.J. Haughton, A.C. Kotchian, L.O. Kitchen, R.A. Anderson, J.K. Horton, D.M. Cochran, and C.S. Gross) either participated in or clearly knew of the improper transactions. These directors, assuming Gaines' allegations are correct, were disqualified from serving as disinterested and independent board members for purposes of the business judgment decision whether to pursue Gaines' derivative lawsuit on behalf of Lockheed. Needless to say, these directors were also interested for purposes of excusing or rendering futile the Fed.R.Civ.P. 23.1 "demand" requirement. Gaines contends further, however, that

> board members who are under the control or influence of the alleged wrongdoers (including current or former officers, employees, members of outside counsel law firms, and others who have an economic or financial relationship to the alleged controlling wrongdoers) cannot be considered disinterested and independent directors under the business judgment doctrine.

For this reason, Gaines argues, four additional Lockheed directors (J. Cross, C. Chappellet, W.M. Hawkins, and C.L. Johnson), making an 11/15 majority, were disqualified.

We assume, without deciding, that in these circumstances Gaines' duty to "demand" that the board of directors vindicate Lockheed's alleged injury in its own behalf would have been futile. *See* Complaint, ¶ 41. We also assume, without deciding, that a majority of Lockheed's fifteen directors were "interested" for purposes of the business judgment rule. It is uncertain whether allegations of "control or influence" should suffice to divest a corporation's directors of their ability to make collective corporate decisions. *Compare Maldonado v. Flynn*, 597 F.2d 789, 793-94 (2d Cir. 1979) ("disinterest" in rule 10b-5 disclosure context is the lack of any concrete financial stake by a director in the transaction under consideration); *Galef v. Alexander*, 615 F.2d 51, 58-62 (2d Cir. 1980) (intimating that a director is "interested" for purposes of overriding directors' refusal of plaintiffs' Rule 23.1 demand and exercise of business judgment to terminate derivative lawsuit only if he

corporation and "wasted" corporate assets by authorizing, employing, and affirmatively concealing corrupt business practices (*i.e.*, the practice of paying large "sales commission," "consulting fees," and outright bribes to foreign purchasers, foreign government officials, and their agents) which resulted in "no use or benefit to Lockheed whatsoever" (Complaint, ¶ 43(a), *see id.* ¶¶ 43(c), (e), 44) and tarnished Lockheed's image and goodwill. *See id.* ¶¶ 17, 30. The class action counts—based on federal securities law—allege that defendants-appellees (hereinafter "appellees") violated the filing and proxy requirements of §§ 13(a) and 14(a) of the Securities Exchange Act of 1934, as amended ("the 1934 Act"), 15 U.S.C. §§ 78m & 78n, by (1) failing to disclose the existence and details of the questionable foreign payments to the shareholders in proxy solicitation materials each year from 1961-74, and (2) by filing materially false and misleading annual and other periodic financial reports on behalf of Lockheed.

Gaines' federal class action claims seek a permanent injunction barring Lockheed from making further improper or undisclosed payments, filing materially false or misleading proxy materials or periodic financial reports, or main-

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authorized or participated in the alleged wrongdoing); and *Findley v. Garrett*, 109 Cal.App.2d 166, 176-77, 240 P.2d 421, 427 (1952) (for purposes of exercising business judgment, a director is incapacitated, *i.e.*, interested, only when allegations of specific facts are pleaded which show actual participation in or concealment of the alleged misconduct), *with Burt v. Irvine Co.*, 237 Cal.App.2d 828, 47 Cal.Rptr. 392, 414-15 (1965) (suggesting that uninvolved directors' business judgment to dismiss derivative suit will be disregarded on the basis of allegations of "domination and control" by corporate wrongdoers). *But see Lewis v. Anderson*, 615 F.2d 778, 783 (9th Cir. 1979), *cert. denied*, — U.S. —, 101 S.Ct. 206, 66 L.Ed.2d 89 (1980) (applying California law) ("To allow one shareholder to incapacitate an entire board of directors merely by leveling charges against them gives too much leverage to dissident shareholders."). *See generally*, Buxbaum, *Conflict-of-Interest Statutes and the Need for a Demand on Directors in Derivative Actions*, 68 Calif.L.Rev. 1122 (1980); Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U.Chi.L Rev. 168, 173-80, 193-96 (1976).

taining any undisclosed accounts. Gaines also seeks a declaration invalidating past elections, removing certain directors, appointing a special master to investigate the payments made, approving new proxy materials, requiring amendment of prior filings, and requiring an accounting of payments made. Gaines does not seek any damages in his § 13(a) or § 14(a) claims.

The *derivative* causes of action seek restitution and money damages for "any and all" disbursements and expenditures in connection with the alleged corrupt business practices and improper foreign payments, including interest, attorneys' fees, and punitive damages.

Apart from the commencement of Gaines' lawsuit, the revelation of Lockheed's foreign payments in July-August 1975 precipitated several other events.[6] On February 2, 1976, the Lockheed board of directors appointed a Special Review Committee[7] (SRC), whose investigation was assisted by the New York law firm Shearman & Sterling and the accounting firm Arthur Anderson & Co. and was directed by the SRC's counsel, former United States District Judge Arnold Bauman. On April 13, 1976, and in response to an SEC complaint, *see SEC v. Lockheed Aircraft Corp.*, [1975-1976 Transfer Binder] Fed.Sec.L.Rep ¶ 95,509 (CCH)

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[6]For a description of the SEC's general response to the disclosure of questionable foreign payments by American corporations, *see* Note, *Disclosure of Payments to Foreign Government Officials Under the Securities Acts*, 89 Harv.L.Rev. 1848, 1850-53 (1976).

[7]The original members of the SRC were four nonmanagement Lockheed directors: Messrs. D.M. Cochran, J.K. Horton, F.M. Vinson, and R.W. Haack. On April 14, 1976, after Gaines commenced his lawsuit, four independent outside directors joined the Lockheed board and were appointed to the SRC. These directors, who later became the Special Litigation Committee, were: J.P. Downer (executive vice president of Atlantic Richfield Co.), H.I. Flournoy (dean of Center for Public Affairs of the University of Southern California), E.L. Hazard (former chairman of Continental Group, Inc.), and J.W. Newman (former chairman of Dun & Bradstreet Cos.).

(D.D.C.1976), Lockheed entered into a consent decree and permanent injunction which enjoined future improper payments, improper accounting methods, and other forms of concealment; required amendment of prior SEC filings; provided for an internal corporate investigation and report procedures to be conducted under SEC supervision; and ordered other remedial actions. On June 23, 1978, Lockheed agreed to a consent order of the Federal Trade Commission containing even more sweeping prohibitions than those contained in the SEC permanent injunction. *See In re Lockheed Corp.*, [1976-79 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 21,454 (FTC Dkt. C-2942, Aug. 17, 1978.)

The SRC conducted a fourteen-month investigation, interviewed more than 250 witnesses, and issued a report (dated May 16, 1977) to the Lockheed board, the SEC, and the United States District Court for the District of Columbia on May 26, 1977. The SRC report, which concluded that Lockheed had, with the approval and participation of several senior executives, made $30-38 million in questionable and "off the books" foreign payments, was distributed to all Lockheed shareholders on June 10, 1977. The SRC report contained a "secret" two-volume appendix prepared by Judge Bauman, which the District Court placed under a protective order on June 10, 1977.

On April 20, 1977, the Lockheed board appointed a Special Litigation Committee[8] (SLC), and delegated to it the full power and authority of the board of directors with re-

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[8]*See* note 7 *supra*.

spect to the then-pending derivative lawsuit.[9] The SLC, composed of four non-defendant outside directors, retained independent outside counsel[10] and, over a period of ten months, considered the factual and legal merit of Gaines' lawsuit. In its March 14, 1978 report, the SLC detailed the factual background of Gaines' lawsuit, enumerated and analyzed a series of factors it deemed definitive of Lockheed's

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[9]This delegation was authorized by Article III, § 15 of Lockheed's bylaws and § 311 of the California Corporations Code. Cal. Corp. Code 311 provides as follows:

> The board may, by resolution adopted by a majority of the authorized number of directors, designate one or more committees, each consisting of two or more directors, to serve at the pleasure of the board. The board may designate one or more directors as alternate members of any committee, who may replace any absent member at any meeting of the committee. The appointment of members or alternate members of a committee requires the vote of a majority of the authorized number of directors. Any such committee, to the extent provided in the resolution of the board or in the bylaws, shall have all the authority of the board, except with respect to:
>
> (a) The approval of any action for which this division also require [sic] shareholders' approval (Section 153) or approval of the outstanding shares (Section 152).
>
> (b) The filling of vacancies on the board or in any committee.
>
> (c) The fixing of compensation of the directors for serving on the board or on any committee.
>
> (d) The amendment or repeal of bylaws or the adoption of new bylaws.
>
> (e) The amendment or repeal of any ressolution of the board which by its express terms is not so amendable or repealable.
>
> (f) A distribution to the shareholders of the corporation (Section 166), except at a rate or in a periodic amount or within a price range determined by the board.
>
> (g) The appointment of other committees of the board or the members thereof.

[10]The SLC retained the New York law firm Cleary, Gottlieb, Steen & Hamilton in May 1977 and the Los Angeles law firm Beardsley, Hufstedler & Kemble in July 1977. The accounting firm Arthur Anderson & Co. conducted an extensive further investigation for the SLC. *See* Special Litigation Committee Report at 7.

interest in pursuing the suit,[11] and unanimously concluded that "sound business judgment as to the interests of Lockheed in light of the circumstances and legal considerations here present leads directly and clearly to the conclusion that the claims asserted in the derivative cases should not be pursued against any of the defendants." Special Litigation Committee Report at 41. Consistent with its decision that the pursuit of the derivative litigation was not in the best interests of the corporation or its shareholders, on March 14, 1978, the SLC directed its counsel to seek dismissal of the derivative claims. Shortly thereafter, Lockheed authorized counsel to seek dismissal of the federal class action claims. These motions were filed in the District Court on April 17, 1978.[12]

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[11]These factors included the following:

1. whether or not each defendant's conduct has been such as to give rise to a cause of action by Lockheed against him;
2. the legal and practical difficulties of sustaining any possible cause of action;
3. the cost to Lockheed in resources of time and money of pursuing any particular claim;
4. the likelihood that, if successful, Lockheed would realize a significant recovery;
5. the effect that dismissal or pursuit of the claims would have on Lockheed's reputation and standing in the business community and elsewhere;
6. the effect the dismissal or pursuit of the claims would have on the morale and adherence to current business practices of Lockheed's employees;
7. the extent to which, if at all, continued litigation would result in disclosures of facts and suppositions harmful to Lockheed and its stockholders as well as to the national interest; and
8. the extent to which, if at all, Lockheed would be damaged by protracted and embittered litigation with its officers past and present.

Special Litigation Committee Report at 9-10.

[12]The motions were formally made and argued on July 17, 1978. On August 16, 1978, while these motions were pending, Gaines moved for partial summary judgment on § 14(a) claims relating to the proxy materials circulated for the 1977 and 1978 director elections, contending that the solicitations were materially misleading as a matter of law. Upon Lockheed's motion, Gaines' motions were put "off calendar." As will be discussed *infra*, we need not address the merits of this issue.

THE DISTRICT COURT DECISION

Judge Whelan's order of summary judgment for appellees was entered on April 20, 1979. The District Court opinion, which contains findings of fact[13] and conclusions of law, is entitled "Memorandum of Grounds Supporting Decision Granting Summary Judgment" [hereinafter "District Court Memorandum"]. Judge Whelan granted summary judgment for appellees on the derivative state law claims because a Special Litigation Committee of disinterested directors, appointed by the full board, had unanimously determined in the exercise of its lawfully delegated[14] independent business judgment that pursuing legal claims against the individual appellees would not be in the best interests of the corporation.

The District Court determined that the decision of the SLC to terminate the derivative lawsuit

> was made in good faith after consideration of relevant factors. There was no fraud, collusion, or other conduct of a breach of trust nature on the part of any member of the Committee.
>
> The Committee's business judgment is not grossly unsound. It cannot be concluded that it did not represent the Committee's honest and independent judgment. . . .
>
> The Court may not substitute its judgment for the good faith business judgment of the Committee which

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[13]While "[f]indings of fact and conclusions of law are unnecessary on decisions of motions under [Fed.R.Civ.P. 56]," Fed.R.Civ.P. 52(a), on the theory that only questions of law—the existence *vel non* of a genuine issue of material fact—are presented, such findings are, nevertheless, permissible and often quite helpful for appellate review. *See* 6 Moore's Federal Practice ¶ 56.02[11] (2d ed. 1976). Such findings are, however, freely reviewable as questions of law. *See Heiniger v. City of Phoenix*, 625 F.2d 842, 843-44 (9th Cir. 1980).

[14]*See* note 9 *supra*.

> is charged with the conduct of the business of the corporation in this matter.
>
> There are no genuine issues of material fact to be tried herein with regard to the Committee's exercise of its business judgment.

District Court Memorandum at 7. Judge Whelan based his holding on this issue on California law. *See Findley v. Garrett*, 109 Cal.App.2d 166, 174, 240 P.2d 421, 426 (1952). His ruling presaged this Court's decision in *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, — U.S. —, 101 S.Ct. 206, 66 L.Ed.2d 89 (1980), which is discussed *infra*.

The District Court also dismissed Gaines' federal securities claims pursuant to Fed.R.Civ.P. 12(b)(6) for failure to state a claim upon which relief can be granted. Because Gaines did not allege in his complaint that he purchased or sold Lockheed stock in reliance on Lockheed's allegedly false and misleading proxy statements and did not allege that he actually granted a proxy based on the allegedly false and misleading proxy solicitation materials, the District Court held that Gaines did not have standing to assert a nonderivative § 14(a) cause of action. "To maintain an [individual, nonderivative] action under Section 14(a), plaintiffs must allege that they granted a proxy based on the alleged false and misleading proxy solicitations . . . . *Klaus v. Hi-Shear Corp.*, 528 F.2d 225 (9th Cir. 1975)." District Court Memorandum at 8-9.

Moreover, because Gaines had not alleged any direct relationship between the proxy materials distributed and the improper foreign payments, Judge Whelan dismissed Gaines' § 14(a) claim for lack of "casual [sic] connection" between the alleged violation and the alleged injury. Alternatively, the District Court dismissed the § 14(a) claim because Gaines sought only declaratory and injunctive relief and

Lockheed had already entered into a consent decree and permanent injunction with the SEC, which enjoined future foreign payments, corrupt and improper business practices, and other conduct that served as the gravamen of Gaines' federal claims. The consent decree also required Lockheed to implement certain reforms and to amend and correct its prior SEC filings. Judge Whelan stated:

> For a grant of injunctive or declaratory relief, the plaintiffs must show that irreparable harm will occur in the absence of such relief. Injunctive relief is not proper where a prior injunction restraining the same conduct has been obtained and is still in force . . . .
>
> [I]njunctive and declaratory relief is improper as a matter of law under these facts.

District Court Memorandum at 9.[15]

STANDARD OF REVIEW

The test to be applied in reviewing the grant or denial of a summary judgment motion is that summary judgment is proper only when there is no genuine issue of any material

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[15]The District Court also dismissed the § 13(a) claim on the ground that § 18(a) of the 1934 Act, 15 U.S.C. § 78r, the exclusive remedy for violations of § 13(a), requires that "plaintiffs allege either a purchase or sale in reliance on the alleged false and misleading statements in order to maintain a cause of action based on . . . Section 13(a)." District Court Memorandum at 8. *Accord, Cramer v. GTE Corp.*, 582 F.2d 259, 269-70 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129, 99 S.Ct. 1048, 59 L.Ed.2d 90 (1979). Gaines does not challenge on appeal the Rule 12(b)(6) dismissal of the § 13(a) claim.

As a subsidiary issue in this case, on June 10, 1977, the District Court granted a protective order pursuant to Fed.R.Civ.P. 26(c), which restricts public dissemination of an appendix to the SRC report. The appendix allegedly contains confidential pricing data and sensitive information regarding the details of the foreign bribes and payoffs. Gaines contends that the protective order, which permits Gaines to review the appendix but forbids xerox or mechanical reproduction, is overbroad and constitutes an abuse of discretion. The trial court, however, normally possesses broad discretion in regulating discovery. *See ISI Corp. v. United States*, 503 F.2d 558, 559 (9th Cir. 1974) (per curiam); 4 Moore's Federal Practice ¶ 26.75 (2d ed. 1979 & Supp. 1980). Our disposition of this appeal relieves us of the need to determine what modifications, if any, would be required of the protective order.

fact or when viewing the evidence and the inferences which may be drawn therefrom in the light most favorable to the adverse party, the movant is clearly entitled to prevail as a matter of law. *Smith v. Gross*, 604 F.2d 639, 641 (9th Cir. 1979); *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1254 (9th Cir. 1976) (per curiam). Phrased differently, an appellate court reviewing a summary judgment "need decide only whether any genuine issue of material fact remains for trial and whether the substantive law was correctly applied." *Inland Cities Express, Inc. v. Diamond National Corp.*, 524 F.2d 753, 754 (9th Cir. 1975). *See Dressler v. MV Sandpiper*, 331 F.2d 130, 133-34 (2d Cir. 1964) (vague and conclusory allegations by party moved against will not prevent a court from screening out "sham issues of fact" and determining whether "one side has no real support for its version of the facts").

As with motions for summary judgment, in reviewing a motion to dismiss, the appellate court should construe the allegations of the complaint favorably to the pleader. *De La Cruz v. Tormey*, 582 F.2d 45, 48 (9th Cir. 1978), *cert. denied*, 441 U.S. 965, 99 S.Ct. 2416, 60 L.Ed.2d 1072 (1979).

Ordinarily, an appellate court can freely review questions of law. *Miller v. United States*, 587 F.2d 991, 994 (9th Cir. 1978). However, when a federal court is in the position of interpreting state law with no definitive guidance from the state's highest court, *see Commissioner v. Estate of Bosch*, 387 U.S. 456, 465, 87 S.Ct. 1776, 1782, 18 L.Ed.2d 886 (1967), we accord "substantial deference" to the district judge's interpretation or construction of the law of the state in which he sits. *Kabatoff v. Safeco Ins. Co. of America*, 627 F.2d 207, 209 (9th Cir. 1980); *Associated General Contractors v. San Francisco Unified School District*, 616 F.2d 1381, 1384 (9th Cir.), *cert. denied*, — U.S. —,101

S.Ct. 783, 66 L.Ed.2d 603 (1980); *Lewis v. Anderson*, 615 F.2d 778, 781 (9th Cir. 1979), *cert. denied*, — U.S. —, 101 S.Ct. 206, 66 L.Ed.2d 89 (1980); *Mesa Oil Co. v. Business Men's Assurance Co. of America*, 476 F.2d 491, 494 (9th Cir.), *cert. denied*, 414 U.S. 1003, 94 S.Ct. 358, 38 L.Ed.2d 239 (1973). The District Court's construction of state law will be accepted on review unless it is "clearly wrong" or "clearly erroneous." *Gee v. Tenneco, Inc.*, 615 F.2d 857, 861 (9th Cir. 1980); *Owens v. White*, 380 F.2d 310, 315 (9th Cir. 1967).

ISSUES ON APPEAL

On appeal, Gaines challenges the order of summary judgment for appellees on the derivative state law claims and the dismissal of the § 14(a) cause of action for failure to state a claim upon which relief can be granted. Specifically, the issues in this appeal are as follows:

1. Whether the District Court correctly applied the "business judgment rule" to the SLC's decision to terminate Gaines' derivative state law claims alleging breach of fiduciary duties by the individual appellees and, if so, whether triable issues of fact exist regarding the special investigative and litigation committees' compliance with the rule.

2. Whether the District Court erred in dismissing the § 14(a) claim on the basis of its holdings that (a) only a shareholder who has himself given a proxy to management has legal "standing" in a nonderivative shareholder action under § 14(a); and (b) "causal nexus" between proxy materials and shareholder injury is lacking as a matter of law when an equitable § 14(a) claim is premised on failure to disclose director misconduct and/or management (other than

self-dealing) in proxy solicitation materials for director elections.[16]

For the reasons discussed herein, we affirm the District Court's invocation of the business judgment rule and dismissal of Gaines' § 14(a) claim.

DISCUSSION

I. The Business Judgment Rule and Corporate Decisions to Terminate Derivative Litigation

In *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, — U.S. —, 101 S.Ct. 206, 66 L.Ed.2d 89 (1980), this court decided that, as a matter of California law, a corporation's board of directors may delegate to a disinterested "special litigation committee" the business judgment authority to dismiss a shareholder derivative lawsuit brought on behalf of the corporation against some of the directors. While *Lewis* is not identical to the instant case—*Lewis* determined only the legal *authority* of the delegation and exercise of the "business judgment rule"; did not pass on the factual determination of whether the committee acted in good faith; and involved derivative *federal* securities claims—it lends strong support to the District Court's holding on this issue.

Drawing on analogous decisions by intermediate appellate courts in California—for the California Supreme Court had not (and still has not) faced the precise issue *sub judice*—this court in *Lewis* amplified the general common law

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[16]Our resolution of the § 14(a) issues permits us to reserve the decision on whether, and to what extent, an equitable § 14(a) claim becomes "moot" when the substance of a plaintiff's requested injunctive or declaratory relief is provided by voluntary remedial measures or other modes of adjudication. See *Browning Debenture Holders' Committee v. DASA Corp.*, 524 F.2d 811, 814-15 (2d Cir. 1975).

"business judgment rule" in two important respects.[17] First, *Lewis* held that a board of directors' general management responsibility and discretion—including the decision whether to pursue a cause of action—may be delegated to a committee of directors.[18] The committee's *good faith* decision that dismissing a derivative action would be in the best interests of the corporation, even if that decision is negligent, bars any further legal action by the shareholder. 615 F.2d at 780, 783-84. The second, and related, holding of *Lewis* is that even when "a majority of the board is charged with wrongdoing in the very action sought to be dismissed," *id.* at 782, they may appoint a committee of disinterested directors "to make an independent determination of the merits of the [derivative] action." *Id.* The application of the business judgment rule to boards of directors with "interested" majorities is not improper because "the directors who are accused of wrongdoing have not decided to dismiss the case," *id.*, a committee of disinterested directors has.

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[17]For a discussion of corporate directors' business judgment authority to, *inter alia*, terminate derivative litigation, *see Burks v. Lasker*, 441 U.S. 471, 478, 480, 485, 99 S.Ct. 1831, 1837, 1838, 1840, 60 L.Ed.2d 404 (1979), *rev'g* 567 F.2d 1208 (2d Cir. 1978); *United Copper Securities Co. v. Amalgamated Copper Co.*, *244 U.S. 261, 263-64, 37* S.Ct. 509, 510-11, 61 L.Ed. 1119 (1917) (Brandeis, J.); *Corbus v. Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463, 23 S.Ct. 157, 160, 47 L.Ed. 256 (1903); *Galef v. Alexander*, 615 F.2d 51, 57-62 (2d Cir. 1980); *Genzer v. Cunningham*, 498 F.Supp. 682, 686-89 (E.D.Mich.1980); *Maldonado v. Flynn*, 485 F.Supp. 274 (S.D.N.Y.1980); *Abbey v. Control Data Corp.*, 460 F.Supp. 1242, 1243-46 (D.Minn.1978), *aff'd*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017, 100 S.Ct. 670, 62 L.Ed.2d 647 (1980); *Gall v. Exxon Corp.*, 418 F.Supp. 508, 514-17 (S.D.N.Y.1976); *Findley v. Garrett*, 109 Cal.App.2d 166, 174, 240 P.2d 421, 426 (1952); *Auerbach v. Bennett*, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979); 3A W. Fletcher, Cyclopedia of the Law of Private Corporations § 1039, at 37-38 (perm. ed. 1975).

[18]*See* note 9 *supra*.

See Gall v. Exxon Corp., 418 F.Supp. 508, 517 (S.D.N.Y.1976).[19]

We noted in *Lewis* that the Eighth Circuit and the New York Court of Appeals have similarly extended the business judgment rule. *See Abbey v. Control Data Corp.*, 603 F.2d 724, 727-30 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017, 100 S.Ct. 670, 62 L.Ed.2d 647 (1980) (applying Delaware law); *Auerbach v. Bennett*, 47 N.Y.2d 619, 629-36, 419 N.Y.S.2d 920, 926-30, 393 N.E.2d 994 (1979) (applying New York law). "*Auerbach* and *Abbey* reflect a clear trend in corporate law, and we are confident that a California court would follow this trend." *Lewis*, 615 F.2d at 783. The role of a court in this situation is limited to determining the disinterested independence of the committee members and the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee. *Id.*

Gaines urges this court to distinguish or limit our holding in *Lewis*, and even to overrule it outright. We decline this invitation to retreat from *Lewis*, for Gaines has offered no persuasive authorities suggesting that this court's reading of California law is no longer tenable. In fact, the developing trend in corporate law we discerned in *Lewis* has become unmistakably clear. *See, e.g., Genzer v. Cunningham*, 498 F.Supp. 682 (E.D.Mich.1980) (applying Michigan law). In addition to *Abbey* and *Auerbach*, many well-reasoned district court decisions have adopted the position that a board of directors may lawfully delegate to a disinterested minority committee the business judgment authority to terminate shareholder derivative litigation because it is either not

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[19]Allegations of an "interested" majority may, however, excuse a derivative plaintiff's failure to make the preliminary "demand" on the board of directors required by Fed.R.Civ.P. 23.-1. *See Cramer v. GTE Corp.*, 582 F.2d 259, 276-77 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129, 99 S.Ct. 1048, 59 L.Ed.2d 90 (1979); note 5 *supra*.

meritorious or not in the best interests of the corporation. *See Maldonado v. Flynn*, 485 F.Supp. 274 (S.D.N.Y.1980) (on remand) (applying Delaware law); *Rosengarten v. ITT Corp.*, 466 F.Supp. 817, 822-24 (S.D.N.Y.1979); *Gall v. Exxon Corp.*, 418 F.Supp. 508, 514-15 (S.D.N.Y.1976) (applying New Jersey law). The contrary holding of the Delaware Chancery Court, an inferior state court, does not counter this trend or impugn our interpretation of California law. *Maldonado v. Flynn*, 413 A.2d 1251 (Del.Ch.1980). *Cf. Maher v. Zapata Corp.*, 490 F.Supp. 348 (S.D.Tex.1980) (following the Delaware Chancery Court's interpretation of Delaware law); *Abella v. Universal Leaf Tobacco Co.*, 495 F.Supp. 713, 717-18 (E.D.Va.1980) (applying Virginia law).

Therefore, we hold that *Lewis v. Anderson* controls in this case. The Special Litigation Committee's decision to terminate Gaines' derivative state law cause of action is, if made in good faith by a disinterested committee of directors, dispositive of Gaines' state law claims. The District Court's prescient anticipation of the *Lewis* interpretation is, in addition, entitled to "substantial deference" and must be affirmed unless "clearly erroneous."

Gaines contends, however, that various factors require remand to the District Court for further findings of fact on the appropriateness and sufficiency of the investigative procedures chosen and pursued by the SLC. Specifically, Gaines argues that Lockheed's delay in establishing the SLC until a year after this suit was commenced is attributable to shopping around for a "friendly" committee. Gaines also alleges that the participation of two "deeply involved" directors in the formation and investigation of the SRC sufficiently tainted the investigative structure and procedures by the later SLC to preclude summary judgment on this issue. Gaines also asserts that the District Court applied an

erroneous legal standard in determining the propriety of the SLC's exercise of business judgment.

While we are mindful of the need to scrutinize carefully the mechanism by which directors delegate to a minority committee the business judgment authority to terminate derivative litigation,[20] particularly when the lawsuit is directed against some or a majority of the directors, we find that Gaines has not raised a triable issue of fact on this issue. The record establishes beyond question that the SLC was composed of independent outside directors whose investigation and recommendations were not tainted by the attenuated involvement of "interested" directors in the formation and preliminary investigation of the SRC. The record also establishes beyond question that the SLC's investigatory procedures were adequate. *See generally Radobenko v. Automated Equipment Corp.*, 520 F.2d 540, 543-44 (9th Cir. 1975). Moreover, we hold that the legal standard employed by the District Court in reviewing the SLC's decision to terminate the litigation comports with this court's statement in *Lewis* that even a negligent decision to dismiss an action is legally dispositive, so long as it is made in good faith. *See* 615 F.2d at 783-84. Accordingly, we conclude that remand is unnecessary. The District Court's order of summary judgment for appellees on this issue is affirmed.

II. The Dismissal of the § 14(a) Claim

Gaines contends that the District Court's Rule 12(b)(6) dismissal of his § 14(a) claim was erroneous because his complaint adequately states a cause of action for equitable relief under § 14(a) of the 1934 Act. Gaines challenges both of the District Court's alternative bases for dismissal—that

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[20] *See Estes, Corporate Governance in the Courts*, 58 Harv.Bus.Rev. 50, 52-60 (July-August 1980).

Gaines lacked "standing" to bring a nonderivative action because he himself had not granted a proxy in reliance on the allegedly misleading solicitation materials and that Gaines' complaint failed to allege the requisite "transactional causation" or "causal nexus." Resolution of these issues requires a brief overview of the § 14(a) cause of action.

Section 14(a) of the 1934 Act, 15 U.S.C. § 78n(a), provides:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, *in contravention of such rules and regulations as the Commission may prescribe* as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect to any security (other than an exempted security) registered pursuant to section 78*l* of this title.

(Emphasis added.) The pertinent SEC regulation, 17 C.F.R. § 240.14a-9 (1980), provides:

> (a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

(b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.

Note: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this section.

(a) Predictions as to specific future market values.

(b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.

(c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.

(d) Claims made prior to a meeting regarding the results of a solicitation.

"The purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation." *J.I. Case Co. v. Borak*, 377 U.S. 426, 431, 84 S.Ct. 1555, 1559, 12 L.Ed.2d 423 (1964). The Supreme Court has recognized an implied private cause of action under that section in favor of stockholders and investors who have been injured as a result of false or misleading

proxy solicitations. *Id.* at 430-31, 84 S.Ct. at 1558-59. *See Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 377, 90 S.Ct. 616, 618, 24 L.Ed.2d 593 (1970).

A. *Standing*

Gaines, who did not grant a proxy in reliance on the contested solicitations, asserts his § 14(a) claim in a direct, not derivative, action seeking only equitable relief. In *Klaus v. Hi-Shear Corp.*, 528 F.2d 225 (9th Cir. 1975), this court recognized that interference with the processes of corporate democracy results in direct harm to the corporation and to shareholders who were actually deceived. "The harm to be averted is only indirectly that to the individual shareholder." *Id.* at 232. *Accord, J.I. Case Co. v. Borak*, 377 U.S. at 432, 84 S.Ct. at 1559. This court stated in *Klaus v. Hi-Shear*:

> Although a demonstration that proxies were obtained by materially misleading solicitation establishes a violation of section 14(a), the relief available to a plaintiff who did not himself grant a proxy depends on equitable considerations based on "the best interest of the shareholders as a whole." *Mills*, 396 U.S. at 388, 90 S.Ct. at 623.
>
> *Klaus did not himself grant a proxy. He is able to assert a section 14(a) violation only derivatively on behalf of Hi-Sheer.* "[N]othing in the statutory policy 'requires the court to unscramble a corporate transaction merely because a violation occurred.' " *Mills*, 396 U.S. at 386, 90 S.Ct. at 622.

528 F.2d at 232 (emphasis added). *Accord, Jacobs v. Airlift International, Inc.*, 440 F.Supp. 540, 542 (S.D.Fla. 1977). *See Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 32-33, 41-42, 97 S.Ct. 926, 944-945, 949-950, 51 L.Ed.2d 124 (1977) (defeated tender offeror has no standing to sue in an implied cause of action under § 14(e)); *Blue*

Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 735-55, 95 S.Ct. 1917, 1925-35, 44 L.Ed.2d 539 (1975) (limiting standing in rule 10b-5 actions to purchasers or sellers of securities); *Mount Clemens Industries, Inc. v. Bell*, 464 F.2d 339, 341-43 (9th Cir. 1972) (same).

Gaines argues that the language from *Klaus v. Hi-Shear* quoted above is dicta, but cites no authority from this Circuit to refute the "standing" rule. We hold that the policies of § 14(a) and established doctrine in analogous securities contexts support the *Klaus v. Hi-Shear* position: shareholders who do not rely on allegedly misleading or deceptive proxy solicitations lack standing to assert direct (as opposed to derivative) equitable actions under § 14(a). Therefore, the District Court's dismissal of Gaines' § 14(a) claim for lack of standing is affirmed. We do not, however, rest our decision solely on this rationale. Even had Gaines granted a proxy to Lockheed's management on the basis of the allegedly defective proxy solicitations, his § 14(a) count would still have been properly dismissed for failure to state a claim. The causation and materiality elements of a § 14(a) cause of action are discussed next.

B. *Transactional Causation and Materiality*

Gaines' § 14(a) claim is ultimately premised on appellees' failure to disclose "corrupt and improper foreign payments" and related corporate misconduct to the Lockheed shareholders in the proxy solicitation materials for director elections each year from 1961 to 1975. The real issue in this appeal is whether, and in what circumstances, management's failure to disclose particular conduct to the shareholders states a § 14(a) cause of action.

The precise roles of "materiality," "causation-in-fact," and "proximate cause" in federal securities litigation are often unclear. *See, e.g., Piper v. Chris-Craft Industries,*

Inc., 430 U.S. 1, 50-53, 97 S.Ct. 926, 953-955, 51 L.Ed.2d 124 (1977) (Blackmun, J., concurring); TSC *Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 444, 448-49, 96 S.Ct. 2126, 2130, 2131-32, 48 L.Ed.2d 757 (1976); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54, 92 S.Ct. 1456, 1472-73, 31 L.Ed.2d 741 (1972); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 381-85, 90 S.Ct. 616, 620-22, 24 L.Ed.2d 593 (1970); *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 716-23 (2d Cir.) (Meskill, J., dissenting), *cert. denied*, — U.S. —, 101 S.Ct. 566, 66 L.Ed.2d 469 (1980); *Weisberg v. Coastal States Gas Corp.*, 609 F.2d 650, 653-55 (2d Cir. 1979), *cert. denied*, 445 U.S. 951, 100 S.Ct. 1600 (1980); *Abbey v. Control Data Corp.*, 603 F.2d 724, 731-32 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017, 100 S.Ct. 670, 62 L.Ed.2d 647 (1980); *Maldonado v. Flynn*, 597 F.2d 789, 795-98 (2d Cir. 1979).

Granted that causation is sometimes presumed when the alleged nondisclosure concealed "material" information,[21] *see Mills v. Electric Auto-Lite Co.*, 396 U.S. at 385, 90 S.Ct. at 622 ("Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment

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[21]An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . Put another way, there must be a substantial likelihood that the disclousre of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449, 96 S.Ct. 2126, 2132, 48 L.Ed.2d 757 (1976). *See generally Zweig v. Hearst Corp.*, 594 F.2d 1261, 1271-72 (9th Cir. 1979) (Ely, J., dissenting) (role of causation and materiality in rule 10b-5 context).

of the [corporate] transaction."), this rationale—the equation of causation to materiality—is logically limited to situations in which shareholder approval was sought (and fraudulently secured) for a transaction requiring such approval, typically so-called "fundamental corporate changes."[22]

In *Mills*, for instance, the Supreme Court made clear that § 14(a) was intended to ensure that proxies would be solicited with " 'explanation to the stockholder of the real nature of the questions *for which authority to cast his vote is sought*,' " 396 U.S. at 381, 90 S.Ct. at 620 (emphasis added), *quoting* H.R.Rep.No.1383, 73d Cong., 2d Sess., 14 (1934); S.Rep.No.792, 73d Cong., 2d Sess., 12 (1934). The purpose of § 14(a) was clearly to prohibit management from deceptively securing stockholder approval for transactions requiring such approval. *See* 396 U.S. at 384-85, 90 S.Ct. at 621-22.

Thus, for *damages* claims relating to the directors' failure to disclose misconduct and/or mismanagement (other than self-dealing or fraud against the corporation), there is no "causal nexus" or "transactional causation," without regard to the issue of materiality, so long as the underlying transaction did not require shareholder approval.[23] The di-

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[22]*See* Carney, *Fundamental Corporate Changes, Minority Shareholders and Business Purposes*, American Bar Foundation Research Journal 69 (Winter 1980).

[23]The cases reject § 14(a) liability for this type of nondisclosure on both "causation" and "materiality" grounds, but we believe the "causal nexus" rationale is, in this situation, the least confusing approach. *Compare, e.g., Maldonado v. Flynn*, 597 F.2d at 796 ("The prevailing definition of a 'material fact' under Rule 14a-9 presupposes that the rule applies only when shareholders are asked to vote. . . . Since Zapata's management did not ask shareholders to approve the modification of the stock option plan, § 14(a) is inapplicable.") *and Bertoglio v. Texas International Co.*, 488 F.Supp. 630, 650 (D.Del. 1980) ("[A] broad view of materiality [under § 14(a)] in the context of election of directors would render meaningless the requirement that the misrepresented or omitted fact relate to the purpose for which proxies

(footnote continued on following page)

rectors' failure to disclose the questionable foreign payments (or other alleged misconduct) is not the legal cause of the pecuniary loss to the corporation, if any. As Judge Henley stated for the Eighth Circuit in *Abbey*:

> Any injury to CDC shareholders from the corporation's illegal foreign payments stems directly from the corporate waste and mismanagement involved in authorizing those payments and not from allegedly misleading proxy solicitations dealing with unrelated corporate business matters. Consequently, we determine that Abbey's § 14(a) claim is . . . at best marginally related to the federal policies underlying that section.

603 F.2d at 732.

In *In re Tenneco Securities Litigation*, 449 F.Supp. 528 (S.D.Tex.1978), the district court employed similar reasoning in dismissing a § 14(a) claim predicated on the nondisclosure of questionable foreign payments.

> The harm to the plaintiffs must have resulted from the corporate transaction they authorized as a result of the false or misleading proxy solicitation. This "transactional causation" is an essential element of a [§] 14 action. . . .
>
> In the instant case, the only "corporate transaction" authorized by the shareholders was the election of directors. The [§] 14(a) violation alleged by the plaintiffs is the failure of the director-candidates to include in their proxy solicitation that they had made the allegedly illegal payments. . . .
>
> In order to recover damages under [§] 14(a) the proxy violation must have caused the economic harm alleged. The economic loss alleged here is the amount

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were solicited."), *with Abbey v. Control Data Corp.*, 603 F.2d at 732 ("Several courts have refused to find a federal remedy under § 14(a) for secret, illegal corporate payments. They have required 'transactional causation' as an essential element of a § 14(a) cause of action: the harm to plaintiff-shareholders must have resulted from the corporate transactions which were authorized as a result of the false or misleading proxy solicitations.").

> of corporate funds allegedly expended for the payments. . . . Such acts of corporate waste and breach of fiduciary duty form the bases of state claims and do not state a claim under the federal securities laws.

Id. at 531 (citations omitted). We conclude that the "causal nexus" or "transactional causation" formulation is the preferable mode of analysis for § 14(a) causes of action pertaining to corporate wrongdoing that did not itself require shareholder approval.

The "transactional causation" approach, which we adopt, requires that the District Court's dismissal of Gaines' equitable § 14(a) claim—to the extent that his claim or requested relief relates to the payments themselves—be affirmed. *See Rosengarten v. ITT Corp.*, 466 F.Supp. 817, 827-28 (S.D.N.Y.1979); *Herman v. Beretta*, [1978 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 96,574 (S.D.N.Y.1978); *Limmer v. GTE Corp.*, [1977-78 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 96,111 (S.D.N.Y.1977); *Lewis v. Elam*, [1977-78 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 96,013 (S.D.N.Y.1977); *Levy v. Johnson*, [1976-77 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 95,899 (S.D.N.Y.1977). *See also Epic Enterprises, Inc. v. Brothers*, 395 F.Supp. 773, 776-77 (N.D.Okla. 1975).

For equitable and declaratory relief claims relating to the *election of directors*, alleged to have been facilitated by the nondisclosure of the underlying misconduct, the causation approach presents problems; as the Second Circuit noted in *Weisberg v. Coastal States Gas Corp.*:

> In [§ 14(a) suits for damages predicated on the directors' subsequent failure to disclose corporate misconduct to the shareholders in proxy solicitations], the plaintiff sought damages because of allegedly improper payments, which did not require shareholder approval. The causal link between the proxy solicitation for the election of directors and the injury complained of—the improper payments—was attentuated at best. In the

> instant case, however, the challenged "transaction" is the election of the directors, and we have no doubt that the "proxy solicitation itself . . . was an essential link in the accomplishment" of that transaction, within the meaning of *Mills*.

609 F.2d at 654.

We agree with the *Weisberg* court that when the plaintiff-shareholder attacks only the election itself, instead of seeking money damages or other relief for the underlying misconduct, the proper analysis shifts from causation to materiality. We draw a sharp distinction, however, between allegations of director misconduct involving breach of trust or self-dealing—the nondisclosure of which is presumptively material—and allegations of simple breach of fiduciary duty/waste of corporate assets—the disclosure of which is never material for § 14(a) purposes.[24] *See Bertoglio v. Texas International Co.*, 488 F.Supp. 630, 650 (D.Del.1980); *Lewis v. Valley*, 476 F.Supp. 62, 65-66

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[24] "The central purpose of the disclosure requirements of the securities acts is to protect buyers and sellers of securities from fraud and to assure that security prices accurately reflect the earning power of the issuer." Note, *supra* note 6, at 1854 (footnotes omitted). "Traditionally it has been supposed that the reasonable investor is only concerned with the return of his investment—that he is only interested in *financially* significant information." *Id.* at 1855 (emphasis in original; footnote omitted). *See Id.* at 1856-70; Weiss, *Disclosure and Corporate Accountability*, 34 Bus.Law. 575, 577, 598, 602 (1979) (the objective of business corporations is to maximize the economic return received by their shareholders; data about a corporation's questionable payments is not clearly significant in any economic sense).

There are clearly instances of illegal conduct by director-nominees, unrelated to self-dealing, *cf.* notes 25-28 *infra* & accompanying text, which would have to be disclosed, especially if they involved criminal convictions. *See, e.g.* Item 3(f) of Regulation S-K, 17 C.F.R. § 229.20; Item 6(a) of Schedule 14A, 17 C.F.R. § 240.14a-101. Our holding is limited to existing directors' duty under § 14(a) to disclose non-criminal conduct in proxy solicitations for their re-election. To paraphrase Judge Conner's statement in *Limmer v. GTE Corp.* [1977-78 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 96,111 (S.D.N.Y.1977), at 92,003, this court declines to endorse "the notion that every election of corporate directors, if unattended by proxy statement confessionals of mismanagement past and contemplated, carries with it the seeds of an action for [injunctive or declaratory relief] premised on Section 14(a)."

(S.D.N.Y.1979) (plaintiff's § 14(a) claim based on nondisclosure of questionable foreign payments in proxy solicitations ordered dismissed because, without element of self-dealing, the undisclosed information was not material); *Amalgamated Clothing and Textile Workers Union v. J.P. Stevens & Co.*, 475 F.Supp. 328, 330-32 (S.D.N.Y.1979) (plaintiff's § 14(a) claim premised on nondisclosure in proxy solicitations of directors' asserted policy to thwart the federal labor laws ordered dismissed because, lacking self-dealing, such information is not material).

The Second Circuit in *Weisberg* discussed this distinction without resolving it. *See* 609 F.2d at 654-55. To the extent that *Weisberg* alters the self-dealing/simple mismanagement dichotomy explicitly enunciated in *Maldonado v. Flynn*,[25]

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[25] Appellant's claim that the proxy statements used to solicit votes for the election of Zapata directors in 1975, 1976 and 1977 were false and misleading in violation of § 14(a) and Rule 14a-9 thereunder, because of their non-disclosure of the true circumstances surrounding the 1974 amendments to the stock option plan, stands on an entirely different footing. *This claim does not present merely another attempt to use § 14(a) and Rule 14a-9 as an avenue for access to the federal courts in order to redress alleged mismanagement or breach of fiduciary duty on the part of corporate executives.* Efforts to dress up claims of the latter type in a § 14(a) suit of clothes have consistently been rejected, including allegations of failure to disclose a disputed legal theory regarding the legality of transactions approved by the board, failure to disclose an alleged ulterior motive for a fully described corporate action, or failure to disclose lack of skill or judgment in approving a transaction intended for the corporation's benefit. Here, in contrast, the alleged misleading statements and non-disclosures involve matters of direct and deep concern to shareholders in the exercise of their right to vote, which the Exchange Act expects to be fully disclosed in proxy solicitations for election of officers and directors. Indeed, the compensation of directors and key officers and transactions between them and their corporation are matters explicitly covered by SEC disclosure regulations. See Schedule 14A, Items, 7, 9-11, 17 C.F.R. § 240.14a-101. *Since self-dealing presents opportunities for abuse of a corporate position of trust, the circumstances surrounding corporate transactions in which directors have a personal interest are directly*

(footnote continued on following page)

Abbey v. Control Data Corp.,[26] and *Galef v. Alexander*, 615 F.2d 51, 65 (2d Cir. 1980),[27] we decline to follow it. The distinction between "mere" bribes and bribes coupled with kickbacks to the directors makes a great deal of sense, indeed, is fundamental to a meaningful concept of materiality under § 14(a) and the preservation of state corporate law.[28] *Cf. Weisberg*, 609 F.2d at 654-55 (pretermitting the issue and concluding that "[b]ecause plaintiff's allegations of a cover-up of massive bribes *and of kickbacks to the directors, if true, would be material to the shareholders in deciding whether to re-elect directors*, we conclude that plaintiff's complaint was prematurely dismissed" (emphasis added)).

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relevant to a determination of whether they are qualified to exercise stewardship of the company. For this reason Rule 14a-9 specifically sets out minimum standards for disclosure and, going beyond the Rule, it has been recognized that shareholders are entitled to truthful presentation of factual information "impugning the honesty, loyalty or competency of directors" in their dealings with the corporation to which they owe a fiduciary duty.

597 F.2d at 796 (emphasis added; citations and footnote omitted).

[26] Illegal foreign payments cases clearly involve state law questions of breach of fiduciary duties. They should not be dealt with under the general disclosure provisions of the federal securities laws where it is apparent, as here, that the nondisclosure of such payments had little, if any, impact on the plaintiff's dealings in the corporation's stock. Several recent cases involving illegal foreign payments have adopted this rationale in dismissing the plaintiff's cause of action for failure to state a claim under § 13(a) or § 14(a).

603 F.2d at 731.

[27] [T]he injuries of which plaintiff complains in these claims are the elections themselves: he seeks to have the elections overturned on account of alleged nondisclosure of certain directors' remuneration. *Since remuneration may be a matter of especial interest in the election of directors, and is indeed the subject of special regulations under § 14(a) . . . there appears to be alleged a sufficient causal link between the claimed nondisclosures in the proxy statements and the elections which the statements sought to influence.*

615 F.2d at 65-66 (emphasis added). Presumably the court in *Galef* meant that matters of director compensation are material because of the potential for self-dealing. *Cf.* note 23 *supra* (distinguishing between causation and materiality).

[28] *See Abbey*, 608 F.2d at 731; note 33 *infra*.

Many corporate actions taken by directors in the interest of the corporation might offend and engender controversy among some stockholders. Investors share the same diversity of social and political views that characterizes the polity as a whole. The tenor of a company's labor relations policies,[29] economic decisions to relocate or close established industrial plants, commercial dealings with foreign countries which are disdained in certain circles, decisions to develop (or not to develop) particular natural resources or forms of energy technology, and the promulgation of corporate personnel policies that reject (or embrace) the principle of affirmative action, are just a few examples of business judgments, soundly entrusted to the broad discretion of the directors, which may nonetheless cause shareholder dissent and provoke claims of "wasteful," "unethical," or even "immoral" business dealings. Should corporate directors have a duty under § 14(a) to disclose all such corporate decisions in proxy solicitations for their re-election?[30] We decline to extend the duty of disclosure under § 14(a) to

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[29]*Amalgamated Clothing and Textile Workers Union v. J.P. Stevens & Co.*, 475 F.Supp. 328 (S.D.N.Y.1979) is perhaps the quintessential example of shareholders' creative—and inappropriate—use of the federal securities laws to attempt to regulate the normative content of corporate policies and management business decisions. *Cf.* Note, *supra* note 6, at 1856-70 (requiring disclosure for the primary purpose of modifying substantive corporate behavior is not authorized by the statutory language empowering the SEC to require reporting for the protection of investors).

[30]Gaines contends that the distinction between director self-dealing and other forms of director misconduct is irrelevant in equitable actions under § 14(a) when the *election* is the challenged "transaction." Gaines posits that while "it would improperly distort the federal securities laws to allow *damage* actions by shareholders for these disclosure failures," the potential for "swallowing" state law standards of care does not exist in *equitable* actions. We disagree. The federalizing effect of granting shareholders such an equitable § 14(a) cause of action would be *even greater* than in the damages context because no pecuniary injury to the corporation would be required to state a claim. Disgruntled shareholders could, in effect, compel a plebiscite on every potentially controversial corporate decision, regardless of the directors' compliance with state law standards of fiduciary duty or the absence of any significant monetary stake. See note 24 *supra* & note 33 *infra*.

these situations. While we neither condone nor condemn these and similar types of corporate conduct (including the now-illegal practice of questionable foreign payments), we believe that aggrieved shareholders have sufficient recourse to state law claims against the responsible directors and, if all else fails, can sell or trade their stock in the offending corporation in favor of an enterprise more compatible with their own personal goals and values.[31]

Absent credible allegations of self-dealing by the directors or dishonesty or deceit which inures to the direct, personal benefit of the directors—a fact that demonstrates a betrayal of trust to the corporation and shareholders and the directors' essential unfitness for corporate stewardship—we hold that director misconduct of the type traditionally regulated by state corporate law need not be disclosed in proxy solicitations for director elections. This type of mismanagement, unadorned by self-dealing, is simply not material or otherwise within the ambit of the federal securities laws. *Golub v. PPD Corp.*, 576 F.2d 759, 764-65 (8th Cir. 1978); *see Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1221, 1222 (9th Cir. 1980). A contrary holding would place an unwarranted premium on the form rather than the substance of a shareholder's complaint[32] and, moreover, would represent a move

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[31]*See generally*, Pilon, *Corporations and Rights: On Treating Corporate People Justly*, 13 Ga.L.Rev. 1245, 1297-1335, 1339-69 (1979); Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251 (1977).

[32]*Cf. Herman v. Beretta*, [1978 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 96,574 (S.D.N.Y.1978), at 94,408:

> Plaintiff seeks to distinguish the instant case [from the damages situation] on the basis of the relief sought here: damages and the voiding of all "tainted" elections. The request for an additional remedy, *i.e.*, the voiding of elections, does not cure the defect in plaintiff's Section 14(a) claim. This Court has not found, nor has plaintiff provided, any precedent or persuasive arguments why injunctive relief should be available to a plaintiff whose complaint fails to meet the "transaction causation" requirement.

toward the federalization of corporate law that the Supreme Court has repeatedly and emphatically rejected.[33]

Accordingly, we affirm the dismissal of Gaines' equitable § 14(a) claim relating to the election of Lockheed directors because the character of the alleged nondisclosures was immaterial as a matter of law.

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[33]In *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477-80, 97 S.Ct. 1292, 1302-05, 51 L.Ed. 480 (1977), the Supreme Court refused to find an implied cause of action under rule 10b-5 because the essence of the complaint was a breach of fiduciary duty of the type traditionally regulated by state law. Expanding implied causes of action under the federal securities law to encompass tangentially implicated instances of mismanagement would, the Court said, exceed Congress' intent, pose a danger of vexatious shareholder litigation, and create potentially insoluble conflicts between state and federal standards. "[W]e are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overriden." *Id.* at 479, 97 S.Ct. at 1304. See *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 40-41, 97 S.Ct. 926, 948-949, 51 L.Ed.2d 124 (1977) (defeated tender-offeror relegated to state law remedies in lieu of expanding § 14(e) cause of action); *Cort v. Ash*, 422 U.S. 66, 78, 84, 95 S.Ct. 2080, 2087, 2091, 45 L.Ed.2d 26 (1975) (corporations are creatures of state law; one of the four factors used to determine whether to imply a private cause of action from a federal statute not expressly providing one is whether "the cause of action [is] one traditionally relegated to state law, in an area basically the concern of the States"); *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12, 92 S.Ct. 165, 168, 30 L.Ed.2d 128 (1971) (by § 10(b) Congress did not seek to regulate transactions "which constitute no more than internal corporate mismanagement").

We agree with the position taken in *Golub v. PPD Corp.*, 576 F.2d 759, 764 (8th Cir. 1978):

> [I]t was not the purpose of the federal security laws to provide a federal cause of action for stockholders who have been damaged by mere corporate mismanagement or breach of fiduciary duty by those in charge of the affairs of the corporation. Controversies in those areas have traditionally been the subject of litigation in the state courts . . . .

Accord, Marbury Management, Inc. v. Kohn, 629 F.2d 705, 723 (2d Cir.) (Meskill, J., dissenting), *cert. denied*, ____U.S. ____, 101 S.Ct. 566, 66 L.Ed.2d 469 (1980); *Healey v. Catalyst Recovery of Pennsylvania, Inc.*, 616 F.2d 641, 651-61 (3d Cir. 1980) (Aldisert, J., dissenting); *Abbey v. Control Data Corp.*, 603 F.2d at 731. *See generally* Ferrara & Steinberg, *A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism*, 129 U.Pa.L.Rev. 263 (1980).

CONCLUSION

For the reasons adduced herein, we affirm the District Court's order of summary judgment on Gaines' derivative state law claims. There is no need for remand. Gaines' allegations do not state an actionable § 14(a) claim, and thus his federal securities claim was correctly dismissed under Rule 12(b)(6).

AFFIRMED.

APPENDIX C.

Memorandum of Grounds Supporting Decision Granting Motion for Summary Judgment, Filed April 20, 1979.

United States District Court Central District of California.

Ora E. Gaines, et al., Plaintiffs, vs. D. J. Haughton, et al., Defendants. CV 76-606-FW.

Lois A. and James Fitzpatrick, etc., Plaintiffs, vs. D. J. Haughton, et al., Defendants. CV 76-1162-FW.

Filed: April 20, 1979.

This matter came on for hearing upon the motion of defendant Lockheed Corporation for summary judgment. The matter was submitted for decision and the Court has heretofore announced its decision that the motion for summary judgment is granted.

The named plaintiffs are stockholders of defendant Lockheed Corporation. Their causes of action are in the nature of stockholders' derivative suit and class action.

The material undisputed facts and the Conclusions of Law of the Court follow.

On February 2, 1976, the Board of Directors of Lockheed Corporation appointed a Special Review Committee to investigate the circumstances of certain payments and commissions in connection with foreign sales which were being questioned by the Securities and Exchange Commission ("SEC"). Messrs. D. M. Cochran, R. W. Haack, J. K. Horton and F. M. Vinson, Jr., were appointed to this Committee.

On April 13, 1976, a permanent injunction was entered and a consent and undertaking was filed with the SEC in response to the Complaint filed in *SEC v. Lockheed Aircraft*

Corporation, [1975-1976 Transfer Binder] C.C.H. Fed.Sec.L.Rep. ¶ 95,509 (D.D.C. 1976).

On April 14, 1976, Messrs. J. P. Downer, H. I. Flournoy, E. L. Hazard and J. W. Newman, were appointed to the Special Review Committee with the approval of the SEC, and on May 3, 1976, Mr. Newman was elected Chairman of the Committee. The scope of the Committee's activities was governed by the consent and undertaking filed with the SEC and the resolution of the Board of Directors establishing the Committee.

The Special Review Committee retained Arnold Bauman, a former United States District Judge, as special counsel, and the New York law firm of Shearman & Sterling and the international accounting firm of Arthur Andersen & Company to assist in its investigation. The Committee heard interviews of witnesses, examined documents and reviewed the activities of the staff, which expended in excess of 50,000 hours of time over fourteen months. By the close of the investigation the Committee and staff had conducted more than 250 interviews and examined over 135,000 pages of documents. Prior to the preparation and submission of the report and the formulation of the conclusions and recommendations contained therein, Messrs. Cochran, Horton and Vinson withdrew their participation in the work of the Committee. Mr. Haack had resigned from the Committee shortly after its formation when he became Chairman of the Board of Lockheed.

On June 6, 1977, the Committee released to the shareholders a report of its investigation which set out the findings and recommendations of the Committee based on its investigation.

Pursuant to the consent and undertaking filed with the SEC on April 20, 1977, Lockheed's Board of Directors

appointed the Implementation Committee. This Committee was initially composed of Messrs. Downer, Flournoy, Hazard and Newman, and was delegated the full power and authority of the Board to ensure Lockheed's compliance with the permanent injunction, the consent and undertaking and the recommendations of the Review Committee. The Implementation Committee has implemented each of the Review Committee's recommendations, except for the recommendation that two-thirds of the members of the Board be "outside" directors or where, by the nature of the recommendation, implementation is an ongoing process that process has begun. Mr. Hazard has not served on the Implementation Committee since September 29, 1977, when his term as a Director expired.

On April 20, 1977, the Board of Directors appointed the Special Litigation Committee to consider the derivative claims asserted in these two subject shareholder derivative actions. Messrs. Downer, Flournoy, Hazard and Newman, each of whom became a Director on April 14, 1976, were originally appointed to this Committee. None of these Directors had any prior involvement with Lockheed or with any of the questionable payments or transactions. In accordance with § 311 of the General Corporation Law, and Article 3, Section 15, of the Lockheed By Laws, the Litigation Committee was delegated the full power and authority of the Board of Directors to determine Lockheed's position in this litigation. Mr. Hazard did not serve on the Special Litigation Comittee after September 29, 1977, when his term as a Director expired.

Dean Flournoy was elected Chairman of the Litigation Committee. Seth M. Hufstedler and the firm of Beardsley, Hufstedler & Kemble, in Los Angeles, and the firm of Cleary, Gottlieb, Steen & Hamilton, in New York, were retained as independent counsel to the Committee.

With the advice of counsel, the Litigation Committee established its procedures for examination of the relevant legal theories and the facts at issue. To supplement the material which they had gathered as members of the Review Committee, the Committee members conducted interviews with all defendants other than Messrs. Haughton and Kotchian, the present Directors of the corporation, members of senior management, and representatives of the corporation's bankers and the staff of the Emergency Loan Guarantee Board. The Committee received counsel's reports and opinions as to the legal theories underlying the claims and the likelihood that the corporation would prevail or obtain any significant recovery in pursuing any of the derivative claims.

On March 14, 1978, the Litigation Committee unanimously adopted a report in which it determined in the exercise of its independent business judgment that it was not in the best interests of the corporation or its shareholders to pursue any legal claims on behalf of the corporation against any of the defendants in the derivative actions, and directed counsel to seek a motion for summary judgment of dismissal with prejudice as to all derivative claims and all defendants.

On March 21, 1978, the corporation authorized counsel to seek a dismissal of the class action asserted in these actions.

The independent Special Litigation Committee, exercising its business judgment in the best interests of Lockheed Corporation and its shareholders, based its decision on a consideration and analysis of a number of factors, including the following:

1. Whether or not each defendant's conduct has been such as to give rise to a cause of action by Lockheed against him;

2. The legal and practical difficulties of sustaining any possible cause of action;

3. The cost to Lockheed in resources of time and money of pursuing any particular claim;

4. The likelihood that, if successful, Lockheed would realize a significant recovery;

5. The effect that dismissal or pursuit of the claims would have on Lockheed's reputation and standing in the business community and elsewhere;

6. The effect that dismissal or pursuit of the claims would have on the morale and adherence to current business practices of Lockheed's employees;

7. The extent to which, if at all, continued litigation would result in disclosures of facts and suppositions harmful to Lockheed and its stockholders as well as to the national interests; and

8. The extent to which, if at all, Lockheed would be damaged by protracted and embittered litigation with its Officers, past and present.

Plaintiffs in both actions fail to allege either a purchase or sale in reliance on the allegedly false and misleading statements contained in Lockheed's proxy statements.

Plaintiffs in both actions fail to allege any direct relationship between the proxy materials distributed and the alleged illegal or improper payments or practices, which were allegedly not discussed in the proxy material.

Plaintiffs in both actions fail to allege that any of the plaintiffs actually granted a proxy based on the alleged false and misleading proxy solicitation materials during the years in question.

The consent and undertaking filed with the SEC and the permanent injunction entered by the SEC against Lockheed restrain the corporation from making illegal or improper

payments violating Sections 13(a) and 14(a) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. §§ 78m-78n (1970), making false or fictitious entries on the corporation's records, and maintaining unaccounted for funds of corporate monies. These documents also require Lockheed to amend and correct its SEC filings, to conduct an investigation through a special committee satisfactory to the SEC and report regarding the questionable payments and practices, which has been done by the corporation. Lockheed must also institute and carry out corporate reforms to prevent any recurrence of questionable payments and practices. This is also being done at the present time by the corporation.

The Court concludes:

The Special Litigation Committee was duly constituted to exercise all powers and authority of the Board of Directors of Lockheed with respect to matters affecting Lockheed Corporation in the derivative actions.

Each member of the Committee is an independent Director and none is motivated by self-interest herein.

The Committee's business judgment to seek dismissal of the action was made in good faith after consideration of relevant factors. There was no fraud, collusion, or other conduct of a breach of trust nature on the part of any member of the Committee.

The Committee's business judgment is not grossly unsound. It cannot be concluded that it did not represent the Committee's honest and independent judgment. *Gall v. Exxon Corp.*, 418 F.Supp. 508 (S.D.N.Y. 1976); *Findley v. Garrett*, 109 Cal.App.2d 166, 240 P.2d 421 (1952).

The Court may not substitute its judgment for the good faith business judgment of the Committee which is charged

with the conduct of the business of the corporation in this matter.

There are no genuine issues of material fact to be tried herein with regard to the Committee's exercise of its business judgment.

The motion of defendant Lockheed Corporation for summary judgment of dismissal with prejudice as to all derivate claims and all defendants should be granted on the basis of the business judgment rule. *Gall v. Exxon Corp.*, 418 F.Supp. 508 (S.D.N.Y. 1976); *Findlay v. Garrett*, 109 Cal.App.2d 166, 240 P.2d 421 (1952).

Section 18(a) of the Securities Exchange Act require [sic] that plaintiffs allege either a purchase or sale in reliance on the alleged false and misleading statements in order to maintain a cause of action based on alleged violations of Section 13(a).

Section 18(a) provides the exclusive remedy for violations of Section 13(a). *Phillips v. Hammer*, No. CV 76-2097 (C.D. Cal., March 24, 1977).

The motion of defendant Lockheed Corporation for dismissal of plaintiffs' claims asserting violations of Section 13(a) should be granted for failure to state a claim upon which relief should be granted.

Section 14(a) of the Securities Exchange Act requires that there be a direct relationship between the proxy solicitations and the material omissions or misstatements alleged. *Mills v. Electric Auto Light Co.*, 396 U.S. 375 (1970).

Any private right of action under Section 14(a) requires that there be a causal connection between the alleged violation and the alleged injury. *J. I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964).

Plaintiffs have failed to establish the required causal connection between the asserted violations and the alleged legal or improper payments and practices.

To maintain an action under Section 14(a), plaintiffs must allege that they granted a proxy based on the alleged false and misleading proxy solicitations. *Phillips v. Hammer*, No. CV 76-2097 (C.D. Cal., March 24, 1977); *Klaus v. Hi-Shear Corp.*, 528 F.2d 225 (9th Cir. 1975).

The motion of defendant Lockheed Corporation for dismissal with prejudice as to the Section 14(a) claims should be granted for failure to state a claim upon which relief can be granted.

For a grant of injunctive or declaratory relief, the plaintiffs must show that irreparable harm will occur in the absence of such relief. Injunctive relief is not proper where a prior injunction restraining the same conduct has been obtained and is still in force. *Harthman v. Witty*, 480 F.2d 337 (3d Cir. 1973); *Howard v. St. Louis-San Francisco Railway Co.*, 361 F.2d 905 (8th Cir.), cert. denied, 385 U.S. 986 (1966).

The motion of defendant Lockheed Corporation for dismissal with prejudice as to the requested injunctive and declaratory relief should be granted on the ground that injunctive and declaratory relief is improper as a matter of law under these facts. Because there are no material undisputed facts this is a proper case for summary judgment.

Defendants are entitled to a summary judgment of dismissal of the derivative claims and to dismissal of the class action claims, and to recover their costs from plaintiffs.

The foregoing constitute the summary of material undisputed facts and the conclusions of law of the Court. Judgment shall be entered accordingly.

Dated: April 20, 1979.

/s/ Francis C.Whelan,
FRANCIS C. WHELAN,
United States District Judge

Opposition

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No. 81-703

IN THE

Supreme Court of the United States

October Term, 1981

ORA E. GAINES, on behalf of himself and other similarly situated shareholders of Lockheed Aircraft Corporation,

Petitioner,

v.

D.J. HAUGHTON, A.C. KOTCHIAN, R.A. ANDERSON C. CHAPPELLET, D.M. COCHRAN, C.S. GROSS, W.M. HAWKINS, J.K. HORTON, C.L. JOHNSON, and LOCKHEED AIRCRAFT CORPORATION,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

RESPONDENT LOCKHEED CORPORATION'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether the court of appeals correctly applied the doctrines of standing and materiality under Section 14(a) of the Securities Exchange Act of 1934 in dismissing claims for equitable relief relating to elections of directors prior to 1975 alleged to have been facilitated by the nondisclosure in proxy materials of internal corporate mismanagement not involving self-dealing.

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No. 81-703

IN THE

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ORA E. GAINES, on behalf of himself and other similarly situated shareholders of Lockheed Aircraft Corporation,

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D.J. HAUGHTON, A.C. KOTCHIAN, R.A. ANDERSON, C. CHAPPELLET, D.M. COCHRAN, C.S. GROSS, W.M. HAWKINS, J.K. HORTON, C.L. JOHNSON, and LOCKHEED AIRCRAFT CORPORATION,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

RESPONDENT LOCKHEED CORPORATION'S BRIEF IN OPPOSITION

Respondent Lockheed Corporation[1] respectfully requests that this Court deny the Petition for a Writ of Certiorari filed herein on October 8, 1981 to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit.

[1] This Brief in Opposition is submitted on behalf of Lockheed Corporation, formerly Lockheed Aircraft Corporation. The following are the names of all subsidiaries (except wholly owned subsidiaries) and affiliates of Lockheed Corporation: CTL Corporation, Honolulu Fueling Facilities Corpo-

(Footnote continued on following page)

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit is reported at 645 F.2d 761 (1981) and appears as Appendix B to the Petition. The Memorandum of Grounds Supporting Decision Granting Motion For Summary Judgment of the United States District Court for the Central District of California is unreported and appears as Appendix C to the Petition.[2]

JURISDICTION

The judgment of the court of appeals was entered on May 18, 1981. On July 10, 1981 the court of appeals denied petitioner's motion for rehearing and suggestion of appropriateness for rehearing en banc. (No judge of the court of appeals requested a vote on the suggestion for rehearing en banc.) The Petition for a Writ of Certiorari[3] was filed October 8, 1981.[4] The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

(Footnote continued from previous page)

ration, Lockheed Aircraft (Australia) Pty. Limited, Lockheed Aircraft Corporation of Canada Limited, Lockheed Corporation (International) S.A., Lockheed Leadership Fund (non-profit), Ocean Minerals, Inc., Portland Fueling Facilities Corporation, Transnational Housing Company, Arizona Fueling Facilities Corporation (inactive), Lockheed-Sait Electronics S.A. (inactive), and Oklahoma Fueling Facilities Corporation (inactive).

[2] Hereinafter citations to the court of appeals' decision will be given as "645 F.2d at ....., Pet.App. at ....." and citations to the district court's decision will be given as "Pet.App. at ....."

[3] Hereinafter citations to the Petition for a Writ of Certiorari will be given as "Pet. at ....."

[4] On November 6, 1981, at the request of respondent Lockheed Corporation, the time for filing this brief in opposition was extended to December 2, 1981.

STATEMENT OF THE CASE

This case, brought by a shareholder of respondent Lockheed Corporation ("Lockheed") against the corporation and certain of its present and former directors, arises from alleged questionable payments relating to foreign sales of Lockheed products.[5] The primary focus of the lawsuit in both the district court and the court of appeals was petitioner's derivative claims asserting state law violations of the fiduciary duties owed by the defendant directors to the corporation. Having lost those state law claims on the merits in the lower courts, petitioner now seeks to continue to litigate them in the form of alleged violations of SEC proxy rules.

Circumstances of the Case

The circumstances surrounding the questionable payments at issue in this case have since 1975 been the subject of investigations and remedial actions by the Securities and Exchange Commission ("SEC"), the Federal Trade Commission, the Internal Revenue Service, various congressional committees, a grand jury in Washington, D.C., and the corporation itself acting through two specially appointed committees of its board of directors, the Special Review Committee and the Special Litigation Committee.

Lockheed, without conceding the truth of the facts alleged or admitting the illegality of any of its conduct, consented in April 1976 to entry of a decree in an action commenced by the SEC, which included a permanent injunction that prohibited any future improper payments, improper accounting methods and other forms of concealment, required amendment of prior SEC filings, provided for an internal corporate investigation and report procedures to be conducted under SEC supervision,

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[5] There are no allegations that Lockheed made improper payments to domestic officials or that any federal criminal laws were violated. As noted by the court of appeals, The Foreign Corrupt Practices Act of 1977, Pub.L.No. 95-213, 91 Stat. 1494, was enacted after the events involved in this action. 645 F.2d at 765 n.1, Pet.App. at 3 n.1.

and ordered other remedial actions. *See* 645 F.2d at 767, Pet.App. at 7.[6] Lockheed is also subject to a consent order of the Federal Trade Commission containing even more sweeping prohibitions than those contained in the SEC permanent injunction. *See In re Lockheed Corp.*, [1976-79 Transfer Binder] Trade Reg. Rep. (CCH) ¶21,454 (FTC Dkt. C02942, Aug. 17, 1978). As a result of these various governmental proceedings and consequent detailed scrutiny of its management practices, Lockheed undertook and carried out a comprehensive program of internal reorganization and corporate reform, including substantial restructuring of its board of directors.

Proceedings in the District Court

The claims asserted in the complaint relevant to the issues raised by the Petition allege that respondents violated the proxy requirements of §14(a) of the Securities Exchange Act, 15 U.S.C. §78n, by failing to disclose the existence and details of questionable foreign payments in proxy solicitation materials each year from 1961-74.[7] Petitioner sought only equitable relief on his §14(a) claims: a permanent injunction barring Lockheed from making further unlawful or undisclosed payments, filing materially false or misleading proxy materials or maintaining any undisclosed accounts; a declaration invalidating past elections; the removal of the directors then in

[6] The text of the 1976 SEC injunctive decree entered by the United States District Court for the District of Columbia and the Consent and Undertaking of Lockheed, incorporated in the final judgment of permanent injunction, is set out in the Appendix to this Brief in Opposition.

[7] The complaint also alleges that respondents violated §13(a) of the Securities Exchange Act, 15 U.S.C. §78m, by filing materially false and misleading periodic financial reports on behalf of Lockheed relating to the questionable foreign payments. That claim was dismissed by the district court on the well-settled ground that a private right of action for violation of §13(a) lies only where a purchase or sale of securities is made in reliance on a false or misleading report, not a circumstance claimed here. *See* Pet.App. at 41. No appeal was taken from that aspect of the district court's decision, *see* 645 F.2d at 769 n.15, Pet. App. at 12 n.15, and the Petition raises no issue with respect to it.

office; the appointment of a special master to investigate the payments made; the circulation of new proxy materials and a new election of directors; amendment of prior SEC and IRS filings; and a full accounting by Lockheed to its shareholders of payments made.

The complaint also asserted derivative claims, based on California law, alleging that the individual defendants as Lockheed directors had breached their fiduciary duty to the corporation and wasted corporate assets by authorizing, utilizing and then concealing corrupt business practices. 645 F.2d at 765-66, Pet.App. at 4-5. Petitioner sought compensatory and punitive damages and restitution of amounts paid.

Pursuant to California law, Lockheed's board of directors appointed a Special Litigation Committee comprised of four independent outside directors recently appointed to the board with the approval of the SEC, none of whom had previously been associated with Lockheed in any capacity, and delegated to the Committee all of its powers with respect to the derivative claims. With the assistance of independent legal and accounting advisors, the Committee conducted an investigation and concluded, in the exercise of business judgment in the light of the relevant legal and other considerations, that maintenance of the derivative actions was not in the best interests of Lockheed or its stockholders. Accordingly, the Committee directed its counsel to seek dismissal of the derivative claims.

The district court granted summary judgment dismissing the derivative claims. The court of appeals unanimously affirmed that dismissal, and the Petition raises no question in this Court with respect to those claims.

Lockheed at the same time moved to dismiss the class action claims for equitable relief. The district court dismissed petitioner's claim under §14(a) of the Securities Exchange Act on three alternative grounds: (1) petitioner failed to allege the required causal connection between the alleged false and misleading proxy materials and the alleged illegal or improper payments and practices; (2) petitioner did not allege that he

personally granted a proxy based on the alleged false and misleading proxy solicitations, an essential element of the individual cause of action; and (3) petitioner had not shown that irreparable harm would occur in the future in the absence of the requested equitable relief since, other than invalidating past elections and removing directors, all of the relief sought by petitioner had been substantially accomplished by virtue of actions of the SEC, the Federal Trade Commission and the corporation itself. Pet.App. at 41-42.

The Ninth Circuit's Decision

The court of appeals affirmed the judgment of the district court rejecting both the derivative claims and petitioner's direct action under §14(a) of the Securities Exchange Act. With respect to petitioner's §14(a) claim the Ninth Circuit upheld the district court's ruling that shareholders who do not rely on allegedly misleading or deceptive proxy solicitations lack standing to assert direct, as opposed to derivative, equitable actions under §14(a). 645 F.2d at 774, Pet.App. at 23. The court expressly stated, however, that its decision did not rest solely on the issue of standing: Even had petitioner granted a proxy to Lockheed's management on the basis of the allegedly defective proxy solicitations, his §14(a) claim would still have been properly dismissed because it failed to allege the required element of materiality. Carefully limiting its holding to existing directors' duty under §14(a) to disclose non-criminal conduct in proxy solicitations for their re-election, 645 F.2d at 777 n.24, Pet.App. at 28 n.24, the court held that nondisclosure of director misconduct of a type traditionally regulated by state corporate law—allegations of simple breach of fiduciary duty or waste of corporate assets "unadorned by self-dealing"—is not material for §14(a) purposes as a matter of law. 645 F.2d at 776-77, 779, Pet.App. at 28-29, 32.

Petitioner's appeal to the Ninth Circuit did not challenge the district court's ruling that he had failed to show irreparable harm and therefore that equitable relief was inappropriate as a

matter of law on his § 14(a) claims. However, because of its rulings with respect to the § 14(a) issues advanced by petitioner, the court of appeals

> "reserve[d] the decision on whether, and to what extent, an equitable § 14(a) claim becomes 'moot' when the substance of a plaintiff's requested injunctive or declaratory relief is provided by voluntary remedial measures or other modes of adjudication."

645 F.2d at 770 n.16, Pet.App. at 15 n.16 (citation omitted).

Petition For Writ Of Certiorari

In his petition for a writ of certiorari to the court of appeals, petitioner does not question the propriety of that court's decision affirming the grant of summary judgment as to the derivative, state law claims. *See* Pet. at i (Questions Presented). Rather, petitioner focuses only on his unsuccessful effort to state a direct claim for equitable relief under § 14(a) of the Securities Exchange Act, based on the nondisclosure in proxy materials of the same instances of internal corporate mismanagement challenged in the now-abandoned derivative claims and already remedied for at least six years by reason of congressional, judicial, administrative and corporate actions.

SUMMARY OF ARGUMENT

The Petition presents no issues warranting review by this Court. The court of appeals' application of the doctrine of standing is fully consistent with the Court's opinion in *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), and does not conflict with any post-*Mills* decision by any other circuit. The courts of appeals' holding on the issue of materiality properly applied the standard announced by this Court in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), and is not in conflict with the decision of the Second Circuit in *Weisberg v. Coastal States Gas Corp.*, 609 F.2d 650 (2d Cir. 1979), *cert. denied*, 445 U.S. 951 (1980), or the decision of any other court of appeals.

Moreover, review of this case would be inappropriate in view of the district court's alternative holding that, because Lockheed had already implemented substantial remedial action, petitioner had failed to demonstrate irreparable injury. That alternative holding renders the standing and materiality issues raised by the Petition abstract at best. Petitioner has failed to demonstrate circumstances that warrant an exception here to the well-established policy against granting review in such cases.

ARGUMENT

I. PETITIONER HAS FAILED TO SHOW THAT THE COURT OF APPEALS' DECISION CONFLICTS WITH DECISIONS OF THIS COURT OR ANY OTHER COURT OF APPEALS, RAISES IMPORTANT ISSUES REQUIRING REVIEW BY THIS COURT OR IS ERRONEOUS

The central element of petitioner's action was the allegation that questionable foreign payments made by Lockheed prior to 1976 had caused it damage properly recoverable from the individual defendants on the ground of breach of their state law fiduciary duties as directors. This contention was presented in derivative claims. The district court, on the basis of the Special Litigation Committee's report, granted Lockheed's motion for summary judgment. Pet.App. at 41. The court of appeals affirmed, and the Petition does not challenge the correctness of that disposition.

Unable to allege individual pecuniary injury, either directly or in respect of the price of Lockheed stock at any relevant time,[8] petitioner also asserted a direct class action

[8] Petitioner's difficulties in that regard are underscored by the finding of the Special Litigation Committee that "the transactions associated with Lockheed's questionable payments resulted in a clear and substantial economic benefit to the corporation." Special Litigation Committee Report at 29. The Committee found that the programs produced approximately $1 billion in revenues and permitted the continuation of production that, if terminated, would have enabled creditors to force Lockheed into bankruptcy. *Id.* at 21-24.

claim against Lockheed, alleging that the nondisclosure of the questionable payments violated the reporting and proxy rules of §§13(a) and 14(a) of the Securities Exchange Act. The complaint sought extensive equitable relief, including the voiding of corporate elections for the period of 1961-74, the appointment of a special master to conduct an investigation of the questionable payments, the holding of new elections and an accounting by Lockheed to its shareholders of the details of the payments. As we show in Section II, below, the substance of this relief has already been granted, so that petitioner's equitable claims are moot, in any event.

The court of appeals, correctly viewing petitioner's Exchange Act claims as an attempt to "federalize" a claim for breach by directors of their fiduciary duty arising under state law, affirmed the district court's dismissal of the proxy claim on two grounds: that petitioner had no standing to allege a claim for direct equitable relief under §14(a) and that the alleged misdeeds, absent allegations of self-dealing, were not material to the challenged elections of directors. In reaching these conclusions the court of appeals did not depart from the principles enunciated in this Court's leading proxy decisions, nor do its conclusions create a conflict among the circuits meriting review in this Court. The court of appeals properly gave heed to the views enunciated in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477-480 (1977), by declining to mandate federal review of "tangentially implicated instances of mismanagement." 645 F.2d at 779 n.33, Pet.App. at 33 n.33.

A. Standing

The court of appeals, following its prior decision in *Klaus v. Hi-Shear Corp.*, 528 F.2d 225 (9th Cir. 1975), held that a plaintiff who has not himself given a proxy obtained by a misleading solicitation has only a derivative, not a direct claim, for equitable relief. Hence, the dismissal of the claim, which petitioner admits is asserted only directly, was affirmed.

None of the prior proxy cases in this Court addresses the issue decided by the court of appeals. Each of this Court's proxy decisions has involved a challenge to corporate amalgamations requiring shareholder approval assertedly obtained by misleading proxy solicitations. *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964) (merger), *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) (merger), and *TSC Industries, Inc. v. Northway, Inc.*, 428 U.S. 436 (1976) (liquidation and sale of assets). In such cases direct pecuniary injury may flow not only to shareholders who participated in the process of corporate democracy and were deceived by the solicitation, but also to those shareholders who did not participate, in their capacity not as voters but as investors. False and misleading proxy materials soliciting votes for directors, on the other hand, injure only those who are deceived. Injury to other shareholders is at most indirect, resulting not from the electoral process but from the subsequent misdeeds of the directors elected.

The two cases on which petitioner relies to create a supposed conflict among the circuits are distinguishable on this ground. *Dann v. Studebaker Corp.*, 288 F.2d 201 (6th Cir. 1961), and *Greater Iowa Corp. v. McLendon*, 378 F.2d 783 (8th Cir. 1967). Both involved proxies to approve specific corporate transactions, rather than elections for directors. In each case the plaintiffs claimed direct injury from the misleading solicitations; no such allegation is or could be made by petitioner.

The court of appeals thus properly held that only shareholders misled by proxy solicitations for the election of directors should be allowed to assert a direct claim for equitable relief with respect to the election. No decision of this Court or of any circuit recognizes a plaintiff's standing to assert a direct, rather than a derivative, § 14(a) cause of action absent such an allegation of direct participation and injury.

B. Materiality and Causation

Numerous decisions of the federal courts hold that alleged nondisclosures in proxy material by which directors were elected are not themselves sufficiently causally related to questionable foreign payments authorized by those directors to permit §14(a) to be used as a vehicle to challenge the questionable payments themselves.[9] Those decisions are plainly proper applications of the principle enunciated in *Mills v. Electric Auto-Lite Co., supra,* 396 U.S. at 385, that to sustain a claim under § 14(a) it must be shown "that the proxy solicitation itself . . . was an essential link in the accomplishment of the transaction."

Petitioner has sought to avoid that result by casting his direct claims as an attack on the election of the directors. The court of appeals recognized that where as here the claim purports to relate to the directors' election itself rather than to the questionable payments (even though the latter are the real focus of the claim), analysis is more complicated. There is no question that the proxy solicitation was, in the terms employed in *Mills,* an essential link in the election. The court of appeals,

[9] *Abbey v. Control Data Corp.*, 603 F.2d 724, 732 (8th Cir. 1979), *cert. denied,* 444 U.S. 1017 (1980); *Rosengarten v. International Telephone & Telegraph Corp.*, 466 F. Supp. 817, 827 (S.D.N.Y. 1979); *In re Tenneco Securities Litigation,* 449 F. Supp 528, 531 (S.D. Tex. 1978); *Herman v. Beretta,* [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,574 (S.D.N.Y. 1978); *Lewis v. Anderson,* 81 F.R.D. 436, 440 (S.D.N.Y. 1978); *Limmer v. General Telephone & Electronics Corp.*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,111 (S.D.N.Y. 1977); *Lewis v. Elam,* [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,013 (S.D.N.Y. 1977); *Levy v. Johnson,* [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,899 (S.D.N.Y. 1977). *See also In re Commonwealth Oil/Tesoro Petroleum Corp. Securities Litigation,* 467 F. Supp. 227, 237-38 (W.D. Tex. 1979); *Oldfield v. Alston,* 77 F.R.D. 735, 743-44 (N.D. Ga. 1978); *Goldberger v. Baker,* 442 F. Supp. 659, 667 (S.D.N.Y. 1977); *Halle & Stieglitz, Filor, Bullard Inc. v. Empress Int'l, Ltd.*, 442 F. Supp. 217, 223 (D. Del. 1977); *Markewich v. Adikes,* 422 F. Supp. 1144, 1146-47 (S.D.N.Y. 1976); *Epic Enterprises, Inc. v. Brothers,* 395 F. Supp. 773 (N.D. Okla. 1975).

agreeing with the Second Circuit opinion in *Weisberg v. Coastal States Gas Corp.*, 609 F.2d 650, 654 (2d Cir. 1979), *cert. denied*, 445 U.S. 951 (1980), concluded that in such a case "the proper analysis shifts from causation to materiality." 645 F.2d at 776, Pet.App. at 28. It held, however, that "allegations of simple breach of fiduciary duty/waste of corporate assets" without accompanying claims of self-dealing are not material for this purpose. *Ibid.* Thus the court of appeals affirmed the dismissal of petitioner's § 14(a) claim, both to the extent that claim might be regarded as directed at the questionable payments themselves, and to the extent that it was directed only at the election of directors.

The insistence by the court of appeals that there be an element of self-dealing before the mismanagement becomes "material" for purposes of §14(a) analysis in the circumstances of this case is sound. The court of appeals expressly followed the test for materiality articulated in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). *See* 645 F.2d at 775 n.21, Pet.App. at 24 n.21, quoting the *TSC Industries* holding. Its decision is also in accord with the decisions of the Second Circuit in *Maldonado v. Flynn*, 597 F.2d 789, 796 (2d Cir. 1979), and *Galef v. Alexander*, 615 F.2d 51, 65 (2d Cir. 1980), and the Eighth Circuit in *Abbey v. Control Data Corp.*, 603 F.2d 724, 731 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980), which likewise emphasize the importance of self-dealing to recognition of a §14(a) claim. *See* 645 F.2d at 777-78, Pet.App. at 28-30.

In each of these cases, the court of appeals held that the election of a director may be set aside where the proxy materials fail to disclose self-dealing that may render the director unqualified to discharge the obligations owed to the shareholders. *E.g., Maldonado v. Flynn, supra*, 597 F.2d at 796. However, the existence of questionable foreign payments themselves, absent director self-dealing, has been held *not* to constitute "relevant and material facts which a reasonably prudent shareholder would have considered in voting on the

questions presented for shareholder approval." *Abbey v. Control Data Corp., supra,* 603 F.2d at 731; *Galef v. Alexander, supra,* 615 F.2d at 65-66.

Contrary to the assertion of petitioner, the decision of the Second Circuit in *Weisberg v. Coastal States Corp.,* 609 F.2d 650 (2d Cir. 1979), *cert. denied,* 445 U.S. 951 (1980), is not in conflict with the decision of the court of appeals. The Ninth Circuit held that:

> "The distinction between 'mere' bribes and bribes coupled with kickbacks to the directors makes a great deal of sense, indeed, is fundamental to a meaningful concept of materiality under §14(a) and the preservation of state corporate law." 645 F.2d at 778, Pet.App. at 30.

The *Weisberg* court acknowledged that developing case law turned upon such a distinction between simple breach of fiduciary duty and self-dealing, but expressly declined to resolve the question whether that distinction was proper. 609 F.2d at 654. Decision of that issue, central to the instant case, was wholly unnecessary to *Weisberg* because the plaintiff had alleged "kickbacks to the directors":

> "Because plaintiff's allegations of a cover-up of massive bribes and of kickbacks to the directors, if true, would be material to the shareholders in deciding whether to re-elect directors, we conclude that plaintiff's complaint was prematurely dismissed." 609 F.2d at 655.

The position to date of the Second Circuit on this issue is thus fully consistent with the decision below.

II. THE SUBSTANTIAL REMEDIAL ACTION ALREADY UNDERTAKEN BY LOCKHEED MAKES THE CASE INAPPROPRIATE FOR REVIEW BY THIS COURT

The issues raised by the Petition concerning the proper application of §14(a) are abstract at best and perhaps moot.

In dismissing the §14(a) claim the district court held that petitioner had failed to show any compelling need for equitable relief. Pet.App. at 42. Noting that injunctive relief is not

proper where a prior injunction restraining the same conduct is in effect, *ibid.*, the court reviewed the substantial requirements imposed by the permanent injunction entered by the SEC against Lockheed and found that all mandated corporate reforms were being implemented. *Id.* at 40. Petitioner does not contend otherwise. *See also* 645 F.2d at 766-68, Pet.App. at 6-9, describing the SEC and Federal Trade Commission injunctions against Lockheed, as well as other remedial action taken by the corporation.

Indeed, it would have been equally proper for the district court to have rejected petitioner's §14(a) claims for equitable relief as moot. The elections prior to 1975 challenged by petitioner are long since concluded. The terms of office of the elected directors are over. The wrongs alleged have been fully remedied.

The right of a private party to obtain a declaration of invalidity as to past elections of directors on the basis of alleged misleading proxy statements under even more compelling circumstances has been uniformly rejected. *See, e.g., Browning Debenture Holders' Comm. v. DASA Corp.*, 524 F.2d 811 (2d Cir. 1975). Plaintiffs in that case argued that the broad, remedial purposes of §14(a) authorized a private action to redress §14(a) violations notwithstanding the "mootness" in the conventional sense of the requested relief. In affirming the dismissal of plaintiffs' claims, the Second Circuit stated:

> "Whatever violations may have occurred in the solicitations of proxies for the 1972 meeting . . . the officers elected then have fulfilled their terms in office (and subsequently been re-elected in 1973 and 1974). . . . When, as here, an issue is rendered moot by plaintiffs' failure to specify monetary damages or other operative relief, and the remedy sought is a mere declaration of law without implications for practical enforcement upon the parties, the case is properly dismissed." 524 F.2d at 814, 817.

The additional equitable relief sought by petitioner likewise has been accomplished. Petitioner asked for appointment of a special master to conduct an investigation of the questionable payments. Compl. p.17, par. 2(c). Pursuant to the 1976 SEC injunctive decree entered by the United States District Court for the District of Columbia and the Consent and Undertaking of Lockheed incorporated in that decree, a Special Review Committee of independent Lockheed directors was appointed with SEC approval. Aided by the independent legal counsel of former District Judge Arnold Bauman and independent accountants, likewise approved by the SEC, the Committee conducted an investigation of unparalleled depth.[10] On the basis of its investigation and report, the Special Review Committee recommended and Lockheed has implemented a wide range of corporate reforms, which in particular give much greater weight and role to the majority of the current board of directors who are independent, outside directors.

Petitioner sought a correction of Lockheed's prior SEC filings. Compl. p.17, par. 2(e). This corrective action is required by Paragraph V of the SEC Injunction. The Special Committee Report, as noted, was not only filed, but also directly disseminated to Lockheed stockholders in connection with the 1977 election of directors. In early 1979 the SEC advised Lockheed that it would seek an order requiring that the Appendix to the Special Committee Report itself be made public unless the Company agreed to file a Form 8-K report containing additional information regarding transactions investigated by the Special Review Committee. In February 1979 such a Form 8-K Report was filed, after extensive discussion

[10] The investigation covered 14 months and involved more than 50,000 hours of staff time. More than 250 interviews were conducted, and more than 135,000 pages of questionnaires, transcripts and other documents were reviewed. Special Review Committee Report at 4-5. *See* Pet.App. at 7. The Report was itself distributed as part of the proxy material for the 1977 election of directors, and the lengthy Exhibits to it were made available free of charge to any stockholder requesting a copy. *Ibid.*

with the staff of the SEC as to its contents. On any view, the issue as to further filings or reports with respect to the questionable payments is moot.

The district court's alternative holding on the issue of irreparable harm, although "reserved" by the Ninth Circuit, 645 F.2d at 770 n.16, Pet.App. at 15 n.16, renders the §14(a) issues presented in the Petition "abstract," if not formally moot. Under these circumstances, further review by this Court would be inappropriate. *See S.S. Monrosa v. Carbon Black Export, Inc.*, 359 U.S. 180, 184 (1959) (dismissing writ of certiorari as improvidently granted):

> "While this Court decides questions of public importance, it decides them in the context of meaningful litigation. Its function in resolving conflicts among the Courts of Appeals is judicial, not simply administrative or managerial. Resolution here of the extent to which these bill of lading provisions may be given effect by our courts can await a day when the issue is posed less abstractly."

Petitioner has failed to demonstrate any circumstances here that warrant an exception to this well-established policy against granting review of academic issues or abstract cases without practical implications for the parties. The §14(a) question raised by Petitioner surely can "await a day when the issue is posed less abstractly," if, indeed, it need be reviewed at all.

CONCLUSION

For the foregoing reasons, the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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APPENDIX

1. FINAL JUDGMENT OF PERMANENT INJUNCTION AGAINST LOCKHEED AIRCRAFT CORPORATION, DATED APRIL 13, 1976

UNITED STATES DISTRICT COURT

FOR THE

DISTRICT OF COLUMBIA

SECURITIES AND EXCHANGE COMMISSION *Plaintiff,* v. LOCKHEED AIRCRAFT CORP. DANIEL J. HAUGHTON A. C. KOTCHIAN *Defendants.*	CIVIL ACTION NO. 76-0611 COMPLAINT FOR PERMANENT INJUNCTION AND CERTAIN ANCILLARY RELIEF

Plaintiff Securities and Exchange Commission ("Commission") having duly commenced this action by filing its COMPLAINT FOR PERMANENT INJUNCTION AND ANCILLARY RELIEF ("Complaint"), and Defendant Lockheed Aircraft Corporation ("Lockheed"), having appeared and admitted to the jurisdiction of this Court over it and over the subject matter of this action; having waived the making of any findings of fact or conclusions of law; before the taking of any testimony and without trial, argument, or adjudication of any issue of fact or law herein; without admitting or denying the allegations of the Complaint, having consented to the entry of this Final Judgment of Permanent Injunction; and having entered into certain undertakings contained in the CONSENT AND UNDERTAKING OF LOCKHEED AIRCRAFT CORPORATION annexed hereto and incorporated herein, without this FINAL JUDGMENT OF PERMANENT INJUNCTION

or CONSENT AND UNDERTAKING constituting any evidence or admission by Lockheed or of its officers or directors with respect to any of the allegations of the Complaint, it is hereby

I

ORDERED, ADJUDGED AND DECREED that Lockheed, its officers, agents, servants, employees, successors, assigns, attorneys, affiliates and subsidiaries, and those persons in active concert or participation with them, and each of them are hereby permanently restrained and enjoined from, directly or indirectly, in connection with the purchase and sale of the securities of Lockheed, its affiliates, subsidiaries or successors, or any other issuer, by use of any means or instrumentalities of interstate commerce, or of the mails, employing any device, scheme or artifice to defraud, making any untrue statement of material fact or omitting to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or engaging in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person concerning:

(a) Any agreement, commitment or understanding by Lockheed or any of its affiliates or subsidiaries to make, or the making of, any payment of corporate funds or other value directly or indirectly to, or for the benefit of, any official or employee of any foreign government or any official or employee of any entity owned and/or controlled by any foreign government;

(b) Any agreement, understanding, arrangement or transaction between officers, directors or employees of Lockheed, any of its affiliates or subsidiaries, and any third person, including consultants, pursuant to which any payment of corporate funds or other value paid to or for the benefit of such third party in whole or in part, directly or

indirectly, is returned or otherwise rebated, not for the benefit of Lockheed, but directly or indirectly for the benefit of any such officer, director or employee;

(c) Any unlawful political contribution by Lockheed, directly or indirectly, to any candidate or political party in any foreign country;

(d) The nature and extent of any false or fictitious entries on the books and records of Lockheed or any of its affiliates or subsidiaries with respect to the matters referred to in subparagraphs (a), (b) and (c), the nature and extent of any fund of corporate monies or other assets established or maintained without being fully and properly accounted for on said books and records, or the nature and extent of payments, disbursements or transfers, if any, therefrom;

(e) The extent to which transfers or disbursements of corporate funds material in nature, amount or effect were or could be effected without the application of adequate accounting or auditing procedures and controls; and

(f) The extent to which any officer, employee or director of Lockheed, or any of its affiliates or subsidiaries, has facilitated or aided and abetted the activities required to be disclosed pursuant to subparagraphs (a) through (e).

II

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that Lockheed, its officers, agents, servants, employees, attorneys, successors, assigns, affiliates and subsidiaries, and those persons in active concert or participation with them, and each of them, are hereby permanently restrained and enjoined from, directly or indirectly:

(a) Violating Section 13(a) of the Securities Exchange Act of 1934 (the "Act"), or Rule 12b-20 or 13a-1 under the Act, by filing or aiding and abetting the filing

with the Commission of materially false and misleading annual or other reports on behalf of Lockheed or any of its affiliates or subsidiaries, concerning the matters referred to in decretal Paragraph I above; or

(b) Violating Section 14(a) of the Act, or Rule 14a-9 thereunder, by using the mails or means and instrumentalities of interstate commerce to file or aid and abet the filing with the Commission of definitive copies of proxy statements or to solicit proxies from shareholders of Lockheed, or any of its affiliates or subsidiaries, by means of proxy statements which are materially false and misleading, concerning the matters referred to in decretal Paragraph I above.

III

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that Lockheed, its officers, servants, employees, successors, assigns, attorneys, affiliates and subsidiaries, and those persons in active concert or participation with them, and each of them, are permanently restrained and enjoined from making, or causing to be made, false and fictitious entries material in nature, amount or effect on the books and records of Lockheed or any of its affiliates or subsidiaries, concerning the matters referred to in decretal Paragraph I above, or establishing or maintaining, or aiding and abetting the establishment or maintenance of, any fund of corporate monies or other assets which is not fully and properly accounted for on said books and records, or making or aiding and abetting the making of any payments, disbursements or transfers therefrom.

IV

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that Lockheed, its officers, directors, servants, employees, subsidiaries, affiliates, attorneys, successors and assigns, and those persons in active concert or participation with them,

and each of them, are hereby permanently restrained and enjoined from entering into any transaction with any other person or entity, pursuant to which invoices are issued by said person or entity, as an accommodation to Lockheed for the purpose of concealing Lockheed's cost from any Lockheed customer with the result that Lockheed's books and records do not accurately reflect the cost incurred by Lockheed pursuant to said transaction.

V

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that Lockheed shall correct and amend its annual and other periodic reports currently on file with the Commission, from 1970 to date, with respect to those matters referred to in decretal Paragraph I above, as set forth in the attached CONSENT AND UNDERTAKING OF LOCKHEED AIRCRAFT CORPORATION.

VI

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that Lockheed, its officers, agents, servants, employees, successors, assigns, attorneys, affiliates, subsidiaries, and those persons in active concert or participation with them, and each of them, shall maintain adequate documentation with respect to those matters referred to in Paragraphs I above, and the Commission shall have continuing access to such documentation.

VII

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that the annexed CONSENT AND UNDERTAKING OF LOCKHEED AIRCRAFT CORPORATION be, and the same hereby is, incorporated herein with the same force and effect as if fully set forth herein.

VIII

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that Defendant Lockheed shall fully comply with its undertakings as set forth in the attached CONSENT AND UNDERTAKING OF LOCKHEED AIRCRAFT CORPORATION.

IX

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that if the terms of the annexed CONSENT AND UNDERTAKING OF LOCKHEED AIRCRAFT CORPORATION concerning the report therein described are not complied with to the full satisfaction of the Commission, the Commission may apply to this Court for an order requiring additional information in the report.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that this Court retain jurisdiction of this matter for all purposes.

_____

UNITED STATES DISTRICT JUDGE

DATED: April 13, 1976
Washington, D.C.

2. CONSENT AND UNDERTAKING OF LOCKHEED AIRCRAFT CORPORATION, ANNEXED TO AND INCORPORATED IN THE FINAL JUDGMENT OF PERMANENT INJUNCTION

UNITED STATES DISTRICT COURT
FOR THE
DISTRICT OF COLUMBIA

SECURITIES AND EXCHANGE COMMISSION *Plaintiff.* v. LOCKHEED AIRCRAFT CORP. DANIEL J. HAUGHTON A. C. Kotchian *Defendants.*	CIVIL ACTION NO. 76-0611 COMPLAINT FOR PERMANENT INJUNCTION AND CERTAIN ANCILLARY RELIEF

(1) Defendant Lockheed Aircraft Corporation ("Lockheed") admits the jurisdiction of this Court over the subject matter of this action and further admits to the service upon it of Summons and Plaintiff Securities and Exchange Commission's ("Commission") COMPLAINT FOR PERMANENT INJUNCTION AND ANCILLARY RELIEF ("Complaint").

(2) Lockheed, without admitting or denying any of the allegations in the Complaint, except as to jurisdiction to which it admits, hereby consents to the entry of the FINAL JUDGMENT OF PERMANENT INJUNCTION in the form annexed hereto.

(3) This CONSENT AND UNDERTAKING OF LOCKHEED AIRCRAFT CORPORATION ("Consent and Undertaking") is executed, and the FINAL JUDGMENT OF PERMANENT INJUNCTION in the form annexed hereto is

entered, without trial, argument or adjudication of any issue of fact or law, Lockheed having waived the entry of findings of fact and conclusions of law. Moreover, neither this Consent and Undertaking nor the FINAL JUDGMENT OF PERMANENT INJUNCTION annexed hereto will constitute or be deemed an admission with respect to any such issue.

(4) Lockheed waives any right it may have to appeal from the FINAL JUDGMENT OF PERMANENT INJUNCTION in the form annexed hereto.

(5) Lockheed enters into this Consent and Undertaking voluntarily, and no promise or threat of any kind whatsoever has been made by the Commission or any member, officer, agent or representative thereof to induce Lockheed to enter into this Consent and Undertaking.

(6) Lockheed agrees that the FINAL JUDGMENT OF PERMANENT INJUNCTION in the form annexed hereto may be presented by the Commission to the Court for signature and entry without further notice.

(7) Lockheed undertakes that its Board of Directors will, within 30 business days from the date of the entry of the Final Judgment of Permanent Injunction, or such further time as is approved by the Commission, create a Special Review Committee (the "Special Committee") to investigate and report to the full Board of Directors on the matters alleged in the Commission's Complaint and with respect to all other relevant matters as may be revealed in the course of such investigation including, but not limited to any direct or indirect domestic use of corporate funds which is unlawful. The Special Committee will consist of members of the Lockheed Board of Directors not presently or formerly members of management and /or persons who are unaffiliated with Lockheed, which Committee shall be satisfactory to the Commission. The Special Committee will, within 10 (ten) days of its selection or such further time as is approved by the Commission, appoint an individual, with the

approval of the Commission, to act as Special Counsel to the Special Committee. The Special Committee will engage such experts as it deems desirable in order to conduct its investigation.

(8) Lockheed undertakes that the Special Committee referred to in paragraph 7 above shall, within 120 days of the FINAL JUDGMENT OF PERMANENT INJUNCTION herein, or such further time as is approved by the Commission, have concluded its investigation with respect to those matters referred to above.

(9) Lockheed undertakes that the Special Committee referred to in paragraph 7 above will conduct an extensive investigation regarding the entire scope of the matters referred to in the Commission's Complaint and such other relevant matters as may be revealed in the course of such investigation, and Lockheed will use its best efforts to ensure that its officers, directors, employees and agents cooperate fully with the Special Committee.

(10) The Special Committee shall prepare and submit a written report (the "Report"), containing its findings and recommendations, to Lockheed's Board of Directors within 30 days, or such further time as is approved by the Commission after it completes its investigation. Lockheed's Board of Directors, acting only through those members found by the Special Committee not to be involved in the transactions and activities set forth in the Commission's Complaint, shall independently review the Report and shall take such action as it determines necessary and proper with respect to implementation of the findings and recommendations of the Report.

(11) Within 30 days after the Report has been submitted to Lockheed's Board of Directors, or such further time as is approved by the Commission, the Report shall be filed with the Commission and with the Court, as part of the record in this action, and as an exhibit to its Current Report on Form 8-K for the month in which the Report is so filed; provided, that it is expressly understood that Lockheed shall have the opportunity,

in advance of the aforesaid filings of the Report, with notice to and opportunity for objection by the Commission, to apply to this Court for a protective order concerning the public release of, and deleting from the exhibit to Form 8-K, those portions of the Report which Lockheed's Board of Directors deems would be harmful to the interests of the corporation and its shareholders and not material under the federal securities laws. Within such period, Lockheed also shall file with the Commission an amendment on Form 8 to its annual reports on Form 10-K for fiscal years 1970 through 1974 and mail a statement to its shareholders. Such amendment and such statement to shareholders shall contain material information from those parts of the Report concerning the matters ser forth in decretal paragraph I of the FINAL JUDGMENT OF PERMANENT INJUNCTION.

(12) Lockheed further undertakes that its Board of Directors, or an appointed committee thereof, shall review on a continuing basis the FINAL JUDGMENT OF PERMANENT INJUNCTION entered herein in the form annexed hereto and this Consent and Undertaking to assure that Lockheed is fully complying with said FINAL JUDGMENT OF PERMANENT INJUNCTION and Consent and Undertaking.

(13) Lockheed represents that its Board of Directors has adopted and implemented and will maintain a Statement of Policies and Procedures ("Statement") with respect to payments by Lockheed to any official or employee of any government or any official or employee of any entity owned and/or controlled by any government unlawful under the laws of the United States or such foreign country, that said Statement will be modified as necessary to assure that it is not inconsistent with the terms of the FINAL JUDGMENT OF PERMANENT INJUNCTION and that said Statement, as so modified, will be filed with the Commission as an exhibit to a Current Report on Form 8-K.

(14) Lockheed represents that in the event there is an intent to change the aforesaid Statement, Lockheed will file a Form 8-K with the Commission, at least 10 days in advance of the date when such a change in policy is scheduled to become effective.

(15) Lockheed further undertakes that Lockheed, its officers, directors, employees and agents will cooperate fully with the Special Committee and the Special Counsel and furnish any information, documents and materials that either may reasonably request in connection with their investigation referred to in paragraph 7 above.

(16) Lockheed further undertakes that Lockheed, its officers, directors, employees and agents will cooperate fully with the Commission and furnish any information, documents and materials that the Commission may reasonably request, and provide to the Commission access to all materials with respect to the matters investigated by the Special Committee, as set forth in paragraph 7 above; provided, however, that with respect to any such information, documents and materials that are privileged or constitute attorney's work product the Commission may have access to such information, documents and materials upon a determination and order of this Court that any such access does not constitute a waiver of such privilege or rule and that any such information, documents and materials shall not be disclosed unless a further order of this Court is issued upon a showing by the Commission that use of such information is necessary in connection with a civil, criminal or administrative proceeding initiated by the Commission or the Department of Justice and that such information is not reasonably available from any other source; and provided further that this Court shall retain jurisdiction over such information, documents, materials and copies thereof and jurisdiction to issue further orders with respect to the matters described in this paragraph as may appear necessary and proper upon appropriate notice to Lockheed; and provided further that nothing in

this paragraph shall be deemed to constitute a waiver of any rights Lockheed may have under the order of the Court dated December 18, 1975, in *Securities and Exchange Commission v. Lockheed Aircraft Corporation* (D.D.C., Misc. No. 75-0189).

(17) Lockheed further consents and agrees that this Consent and Undertaking shall be incorporated by reference in the FINAL JUDGMENT OF PERMANENT INJUNCTION, in the form annexed hereto, to be entered by the Court in this Action.

By: /s/ JAMES J. RYAN

Secretary

Petitioner's Reply Brief

Office-Supreme Court, U.S.
FILED
DEC 18 1981
ALEXANDER L. STEVAS,
CLERK

CORRECTED COPY

No. 81-703

IN THE

Supreme Court of the United States

October Term, 1981

ORA E. GAINES, on behalf of himself and other similarly situated shareholders of Lockheed Aircraft Corporation,

Petitioner,

vs.

D. J. HAUGHTON, A. C. KOTCHIAN, R. A. ANDERSON, C. CHAPPELLET, D. M. COCHRAN, C. S. GROSS, W. M. HAWKINS, J. K. HORTON, C. L. JOHNSON, and LOCKHEED AIRCRAFT CORPORATION,

Respondents.

PETITIONER'S REPLY BRIEF

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Respondents.

PETITIONER'S REPLY BRIEF

In its Brief in Opposition, respondent Lockheed virtually eschews addressing the merits of the important legal issues raised by this case, but instead seeks to portray petitioner's federal securities law claims as "abstract," "academic," and perhaps moot, thus unworthy of the consideration of this Court. Although Lockheed's contention in this regard may be clever litigation strategy, it is nevertheless refuted both by the facts of this case and by the untoward impact on enforcement of the federal securities laws that will result if the Ninth Circuit's opinion is left to stand without further examination. Indeed, these "serious adverse effects" were expressly recognized by the Securities and Exchange Com-

mission in its amicus curiae brief forcefully urging rehearing on petitioner's behalf below. *See generally* Petition for Writ of Certiorari ("Petition"), at 7-8, 12, 20-22.

ARGUMENT

I.

This Case Is Distinctly Appropriate for Review.

Lockheed argues that the issues raised by petitioner are without practical implications because the SEC previously obtained a consent decree injunction against the corporation which generally prohibited future improper payments and false accounting methods used to conceal such payments, and which further required that an internal investigation be conducted by Lockheed into such improper payments and accounting methods. Respondent contends that petitioner's section 14(a) claims for equitable relief are therefore moot, since the corporation's alleged wrongdoing has purportedly been "fully remedied." Respondent's Brief in Opposition ("Opposition Brief"), at 3-4, 13-16. Lockheed's argument, however, is wrong both on the law and on the facts.[1]

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[1]Lockheed not only misstates the District Court's ruling as having factually concluded that "all of the relief sought by petitioner had been substantially accomplished," *see* Opposition Brief, at 6, but also misleadingly asserts that petitioner has conceded the validity of this ruling by not challenging it on appeal. *Id.* In fact, however, the District Court held only that "injunctive relief is not proper where a prior injunction restraining the same conduct has been obtained and is still in force." Petition App., at 42. On appeal, petitioner vigorously contested this erroneous legal conclusion, *see generally* Appellant's Opening Brief below, at 34-35; Appellant's Reply Brief below, at 8-16, and the Ninth Circuit's opinion acknowledged the challenge but expressly reserved decision on that issue. Petition App., at 15 n.16. Indeed, petitioner has consistently urged that the wrongful conduct at issue here has reoccurred, that new director elections have been held based on new proxy materials that were themselves materially misleading, and that summary judgment should be granted to petitioner enjoining further dissemination of misleading proxy materials and voiding the most recent elections based on those materials. *See* Appellant's Opening Brief below, at 34-35; Appellant's Reply Brief below, at 8-16.

To begin with, as a long line of cases have uniformly recognized, the existence of a consent decree enjoining certain conduct obtained in public agency litigation does not preclude or limit the granting of injunctive relief in subsequent litigation brought by private parties. *E.g.*, *Sam Fox Publishing Co. v. United States*, 366 U.S. 683 (1961) (government antitrust decree does not bind private parties litigating same claim); *Williamson v. Bethlehem Steel Corp.*, 468 F.2d 1201 (2d Cir. 1972) (government agency consent decree in Title VII Civil Rights Act case does not limit relief sought by private litigants in subsequent suit); *Bryan v. Pittsburgh Plate Glass Co.*, 494 F.2d 799 (3d Cir. 1974) (same); *Boyd v. United States*, 345 F.Supp. 790 (E.D.N.Y. 1972) (government agency consent agreement does not foreclose private parties from seeking additional relief in Fair Housing Act case). These cases reason that the public action is brought to protect public, rather than private, rights, and that the private litigant may have very different interests to protect than the public agency. Moreover, the public agency action may be affected by limited governmental resources or by consideration of matters adverse to the private litigant, and may simply seek to establish minimum levels of compliance.

Even more fundamentally, however, the equitable relief sought by petitioner in this case goes far beyond the generalized injunction obtained by the SEC in its earlier consent decree — a fact expressly recognized by the SEC in its amicus brief on petitioner's behalf below. SEC Amicus Brief, at 4 n.1 ("The private plaintiff in this case seeks certain equitable relief against the defendants in the [SEC's] action, beyond the relief obtained by the [SEC]"). Briefly summarized, some of the primary distinctions between the terms of the SEC's consent decree and the relief sought by petitioner include the following:

- The SEC consent decree provided only for an informal "internal investigation" to be conducted by certain Lockheed directors (the Special Review Committee or "SRC") with the assistance of Special Counsel. Petitioner's complaint seeks judicial appointment of a special master to conduct a full and impartial investigation into these matters, or, failing that, use of the formal discovery procedures available to any plaintiffs in civil litigation. In either event, the investigation would be conducted under oath and with use of the subpoena and other compulsory processes of the federal court — procedures which were conspicuously lacking in Lockheed's "internal investigation." Indeed, several key Lockheed employees who participated in the illegal and improper activities simply refused altogether to be "interviewed" by the Lockheed directors who conducted the internal investigation, while other employees refused to answer specific questions posed by the SRC, and the directors who sat on the SRC participated in the sham of interviewing themselves about their own earlier conduct. *See* Appellant's Opening Brief below, at 14, 21-22.

- Similarly, petitioner's complaint seeks an accurate accounting of Lockheed shareholder funds. Due in part to the informal procedures followed by the SRC, the "internal investigation" conducted pursuant to the SEC consent decree was able to make only a rough "estimate" of the amount of funds improperly spent (and which the SRC admittedly could not accurately trace), and it was unable to account at all for several million dollars in shareholder funds. *Id.*, at 22-23.

- In addition, petitioner's complaint requests that all material information regarding the improper payments and false accounting methods be disclosed to the Lockheed shareholders, and that new director elections be held based on proxy materials which fully and accu-

rately disclose the role of all director candidates in these activities. Although the SEC consent decree called for the SRC's internal investigation into these matters, when the SRC Report came to be written, the detailed section regarding director involvement in these matters authored by its Special Counsel (former U.S. District Judge Arnold Bauman) was omitted from the Report, and, over Judge Bauman's strenuous urging to the contrary, was converted by the SRC into a still-secret "appendix" that was never made public nor sent to the Lockheed shareholders. *Id.*, at 15-17. Petitioner has consistently argued that this secret appendix (reviewed by petitioner's counsel under the District Court's protective order) directly contradicts the SRC Report sent to Lockheed shareholders regarding the improper payments authorization, implementation, and concealment activities of certain directors. Those directors continue to sit on the Lockheed board and have repeatedly been reelected on the basis of the misleading proxy materials sent to the shareholders. *See id.*, at 16-22. Petitioner has therefore requested that the most recent election of the involved directors be voided or set aside, and that new elections be held based on proxy materials accurately disclosing the pertinent facts set out in the secret appendix.[2]

In summary, Lockheed's self-serving statements that this case is "moot" and that "all of the relief sought by petitioner [has] been substantially accomplished" are completely unfounded. The instant case, which ironically arises

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[2]Because of the District Court's erroneous "causation" ruling and the Ninth Circuit's erroneous *per se* "materiality" ruling, no court to date has even considered whether the specific misstatements and nondisclosures alleged should properly be the subject of amended proxy materials for new director elections. *See* Petition, at 5.

out of one of the major corporate scandals of the twentieth century, could hardly be less "abstract" or more "ripe" for consideration.

II.

Contrary to Respondent Lockheed's Contention, the Questions Presented Here Are of Great Importance to the Enforcement of the Federal Securities Laws by the Securities and Exchange Commission and by Private Actions.

In an attempt to minimize the significance of the federal securities law issues raised by the Petition for Writ of Certiorari, respondent Lockheed seeks to characterize the claims and extensive equitable relief requested by petitioner under section 14(a) as somehow subsidiary to the state law derivative causes of action. On the contrary, however, petitioner's federal claims are, and always have been, the central thrust of this litigation. Petitioner's complaint does not simply seek to compensate the Lockheed shareholders for specific economic damage resulting from the directors' alleged misconduct in concealing and misrepresenting their activities relating to the improper payments, but more importantly, it seeks to remedy the harm that such misconduct inflicts upon the integrity of the corporate reporting and disclosure system that is the cornerstone of federal regulation of the securities markets.

Thus, not only is resolution of the questions raised in this Petition crucial to the instant litigation, but the implications of the Court's decision whether to hear this case will extend well beyond the confines of this single lawsuit. If permitted to stand, the Court of Appeals' erroneous interpretation of the "standing" and "materiality" requirements of section 14(a) will significantly narrow the investor protections afforded by that provision and could — in the words of the

SEC below — "have serious adverse effects both on the enforcement of the federal securities laws by the Commission and on the maintenance of private rights of action under these laws." Motion of the SEC to File a Memorandum, Amicus Curiae, Out of Time, at 1.

Lockheed endeavors to provide a rationale for the Ninth Circuit's holding that shareholders who are not personally deceived by misleading proxy materials seeking election of directors do not have "standing" to bring a section 14(a) equitable claim for relief. Although this rationale is nowhere expressed in the Ninth Circuit's opinion below, Lockheed argues that such shareholders have only an unimportant "indirect" injury, not meriting sufficient judicial recognition to provide standing. Opposition Brief, at 10. Lockheed distinguishes *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), and decisions by at least two other circuit courts that have expressly *granted* section 14(a) standing to non-deceived shareholders, on the tenuous ground that those cases arose in the context of "corporate amalgamations requiring shareholder approval." In such cases, Lockheed argues, a "direct pecuniary injury" may flow to non-deceived shareholders in their capacity "not as voters but as investors." Opposition Brief, at 10.

This argument ignores the obvious fact that "the election of a board of directors may be the most important, and in some cases the only, transaction in which the stockholder has any significant voice in determining the company's destiny." *Rafal v. Geneen*, 1972 CCH Fed. Sec. L. Rep. ¶93,505, at 92,440 (E.D. Pa. 1972). Equally telling, the plaintiff who does not rely on misleading proxy materials about management-sponsored directors is injured in the same manner as those who are deceived and who do grant

proxies to management — the wrongdoing directors continue to hold office and to manage the company's affairs because they have successfully deceived other shareholders. Precisely for these reasons, the SEC forcefully argued below that the Ninth Circuit's "standing" holding in this case "severely restricts" private rights of action under section 14(a) on the basis of "no rationale." SEC Amicus Brief, at 5, 21-22.

Without further elaboration, Lockheed also baldly asserts that the Ninth Circuit's insistence upon an "element of self-dealing" before director misconduct becomes "material" is "sound." Opposition Brief, at 12. Although Lockheed does attempt, albeit unsuccessfully, to distinguish the Second Circuit's contrary holding in *Weisberg v. Coastal States Gas Corp.*, 609 F.2d 650 (2d Cir. 1979), *cert. denied*, 445 U.S. 951 (1980), a case virtually identical to the instant one, Lockheed nowhere acknowledges or refutes the wide variety of cases that reject the reasoning of the Ninth Circuit below. *See* Petition, at 18-19. Nor does Lockheed confront the disastrous impact the decision below will have on the SEC's widely applied "Voluntary Disclosure Program" and other enforcement activities regarding illegal and questionable corporate payments, and the SEC's well-articulated rationale supporting its conclusion that the director misconduct at issue here is clearly "material" to shareholders voting for Lockheed directors. *See id.*, at 7-8, 20-23. The significance of the federal securities law issues raised in this case, as well as the widespread and adverse effects that will result from the Court of Appeals' resolution of those issues, mandate this Court's review of the decision below.

CONCLUSION.

For the foregoing reasons, the Petition for a Writ of Certiorari should be granted.

December 11, 1981.

Respectfully submitted,

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